THE EVOLVING ROLE OF SHAREHOLDERS AND THE FUTURE OF DIRECTOR PRIMACY THEORY

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ABSTRACT

Over the last two decades, US corporate governance has witnessed a significant increase in the incidence and influence of shareholder activism. Shareholder activism, however, has been found to be inconsistent with US corporate governance which is framed within director primacy theory. In this theory, the board is able to carry out a unique combination of managerial and monitoring roles effectively, and shareholders are only capital providers to companies. Shareholder activism is normatively found inimical to effective and efficient decision-making, i.e. the board's authority, and to the long-term interests of public companies. The increasing willingness of institutional shareholders to participate into the decision-making processes of their portfolio companies is at odds with US corporate governance. Therefore, the aim of this thesis is to examine whether director primacy theory should be softened to accommodate greater shareholder activism in US corporate governance.

This thesis presents an analysis of the legal rules that reflect director primacy theory. In this respect, US shareholders have traditionally had limited participatory power. The way in which the courts perceived the board's authority also stymied shareholder participation. This thesis considers not only legal and regulatory developments in the wake of the 2007-2008 financial crisis, but also the governance developments through by-law amendments which could potentially make an overall change in the balance of power between shareholders and the board. Shareholders are slowly moving to the centre of corporate governance in the US.

History has shown that the board of directors often failed to prevent manager-induced corporate governance failures. This thesis argues that shareholder activism is necessary for improving the web of monitoring mechanisms and for a well-functioning director primacy model. Shareholder activism forces the board to more critical about management, which is a prerequisite for the director primacy model. Therefore, this thesis argues that shareholder activism should therefore be accommodated into US corporate governance. The proposed approach addresses accountability problems more effectively than the current director primacy model while recognising the board authority and enhances decision-making processes of public companies. In this regard, it makes several recommendations to soften the current director primacy model: establishing a level playing for private ordering, adopting the proxy access default regime, the majority voting rule, the universal proxy rules, and enhancing the disclosure requirements of shareholders.

The present research also demonstrates that contemporary shareholder activism involves many complexities. It contains different types of shareholder activism, which differ by objectives, tools, and motives. It could be used for purely financial purposes or non-financial purposes or both. Furthermore, the concept of stewardship has been developed to address public interest concerns, namely short-termism in the market and pressures by activist funds through shareholder activism. In this way, this thesis develops a complete positive theory about shareholder activism rather than focussing on a specific type of activism. This complete analytical framework constitutes more reliable basis to draw normative conclusions rather than focussing on a particular type of activism.

LAY SUMMARY

Shareholder activism has become very topical in the wake of the 2007-2008 financial crisis. Institutional shareholders, in particular activist funds, are criticised for forcing companies to pay out their profits immediately and for pursuing short-term interests at the expense of the long-term interests of companies and other stakeholders, such as employees or creditors. The board and management, therefore, are compelled to transfer wealth from the company to shareholders. Institutional shareholders are regarded as ‘short-term’ predators who only focus on increasing share prices before its long-term impact on the company is felt. In this respect, shareholder activism has negative implications on the economy, society and even the environment by preventing the board and management from exercising their authority independently. It has often been argued that the board and management should be insulated from shareholder activism.

This thesis demonstrates that we should not think that self-interested and short-term institutional shareholders are the only institutional shareholders in the market. Not all institutional shareholders are short-term investors. On the contrary, mainstream institutional shareholders are primarily long-term investors. They had been traditionally passive investors. In the aftermath of the financial crisis, they began investment policies that sought to build long-term investments in their portfolio companies and take into consideration non-financial concerns. Activist funds are different from mainstream institutional shareholders. They are relatively short-term investors that seek to obtain abnormal returns. They aim to make controversial changes such as the sale of a department of the target company, spinoff of a subsidiary company or reduce R&D spending at the target companies. Despite this negative image, activist funds play a key role in corporate governance. They raise legitimate question in the boardroom and between shareholders and serve an important monitoring role over underperforming boards and management teams.

This thesis, therefore, argues that shareholder activism broadly benefits shareholders, companies and capital markets. So, company law should encourage shareholders to be active while preserving sufficient independence for the board and management. In this way, shareholders could contribute new ideas as well as financial and non-financial concerns into the corporate decision-making process.

DECLARATION

I hereby declare that this thesis and the work presented in it are my own and has been written by me in its entirety and no portion of this thesis has been used in support of an application of another degree in qualification to this or any other university.

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List of Abbreviations

ABI	Association of British Insurers
ACCA	The Association of Chartered Certified Accountants
BIS	Department for Business, Innovation, & Skills
CA 2006	Companies Act 2006 (UK)
CGC	The UK Corporate Governance Code
CFA Institute	CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics
CII	Council of Institutional Investors
CUP	Cambridge University Press
DGCL	Delaware General Corporation Law
Dodd-Frank Act	The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010
DTI	Department of Trade and Industry
ECGI	European Corporate Governance Institute
ERISA	The Employee Retirement Income Security Act of 1974
EU	European Union
FSA	Financial Services Authority
FRC	Financial Reporting Council
HLSFCGF	Harvard Law School Forum on Corporate Governance and Financial Regulation
IMA	Investment Management Association
ISG	Investor Stewardship Group
MBCA	Model Business Corporation Act
NAPF	National Association of Pension Funds
NEDs	Non-Executive Directors
OUP	Oxford University Press
PIRC	Pensions Investment Research Consultants Ltd
PLSA	Pensions and Lifetime Savings Associations
SC	Stewardship Code
S. Ct.	Supreme Court of United States
SEC	Securities Exchange Commission
SOX	Public Company Accounting Reform and Investor Protection Act (The Sarbanes–Oxley Act of 2002)
OECD	Organisation for Economic Co-operation and Development

Chapter 1. Introduction

1.1 Background to this Research

The primary aim of this thesis is to examine the question of whether director primacy theory should be softened to accommodate greater shareholder activism in US corporate governance. In doing so, this study builds a theoretical framework for the evolving role of shareholders in the US to analyse how the role of shareholders has been incorporated into practice in the US and to examine whether it should be further accommodated into US corporate governance. Under US corporate governance, directors are vested with authority to manage the company. The board of directors is generally protected from shareholder interference; therefore, US corporate governance is described as one that adopts the director primacy theory as the best means to ensure shareholder wealth. However, there have been significant market and policy developments that incentivise and encourage shareholders to participate in the management of companies. This causes tension between directors and shareholders in the US. This thesis, therefore, investigates whether shareholders should be further accommodated into US corporate governance by considering the potential benefits and side effects of shareholder activism.

In its simplest definition, corporate governance is a 'system by which companies are directed and controlled'.[1] It contains a combination of legal rules and principles which have been developed over time and are based on the distinctive features of each nation's legal and financial tradition.[2] If one needed to categorise corporate governance systems, it could be done under two major types: the 'outsider' (Anglo-American) and the 'insider' (continental European) models.[3] The primary differences between these dichotomous corporate governance models are the share

[1] Adrian Cadbury et al., *Report of the committee on the financial aspects of corporate governance* (Gee, 1992), para 2.5.
[2] Thomas Clarke, *International Corporate Governance: A Comparative Approach* (2007, Abingdon: Routledge), 170.
[3] See, Christine Mallin, *Corporate Governance* (4th edition, OUP, 2013) Chapter 10; Ruth Aguilera and Gregory Jackson, 'The Cross-National Diversity of Corporate Governance: Dimensions and Determinants' (2003) 28 *Academy of Management Review* 447.

ownership structure of public companies and their predominant objectives of public companies.[4] With regard to the share ownership of companies, in outsider corporate governance models, shares of large companies are usually held by widely dispersed shareholders and this contrasts with companies in continental Europe and the insider model where large companies tend to have a controlling shareholder.[5] The ownership of shares is, therefore, separated from the control in outsider corporate governance models. As regards the objectives of public corporations, in outsider corporate governance models the maximisation of shareholders' wealth prevails as the fundamental objective of public corporations, while in insider corporate governance models, corporations tend to embrace the interests of different stakeholders such as employees, creditors, and suppliers.[6]

The similar ownership pattern and objectives of public companies gave rise to the implicit assumption that there is a unified and stable Anglo-American corporate governance model. This assumption is rightfully challenged in the literature on the grounds of its failure to take into account the allocation of powers between shareholders and directors.[7] In this respect, a further distinction is made between director primacy and shareholder primacy, depending on whether directors or shareholders should have ultimate control over corporate affairs.[8] US corporate

[4] Ruth Aguilera and Gregory Jackson, 'The Cross-National Diversity of Corporate Governance: Dimensions and Determinants' (2003) 28 *Academy of Management Review* 447; John Armour, Simon Deakin and Suzanne Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41(3) *British Journal of Industrial Relations* 531, 533; Ruth Aguilera, 'Corporate Governance and Director Accountability: an Institutional Comparative Perspective' (2005) 16 *British Journal of Management* 39.

[5] Cynthia Williamson and John Conley, 'An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct', (2005) 38 *Cornell International Law Journal* 493, 498; Ruth Aguilera and Gregory Jackson, 'The Cross-National Diversity of Corporate Governance: Dimensions and Determinants' (2003) 28 *Academy of Management Review* 447, 448-450; Ruth Aguilera et al, 'Putting the S Back in Corporate Social Responsibility' (2007) 32(3) *The Academy of Management Review* 836, 845.

[6] see, Andrew Keay, 'Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's 'Enlightened Shareholder Value Approach'' (2007) 29 *Sydney Law Review* 577; Aguilera (n 5), 836-863.

[7] Stephen Bainbridge, 'Director v. Shareholder Primacy in the Convergence Debate' (2002) 16 *The Transnational Lawyer* 45.

[8] Stephen Bainbridge, *The New Corporate Governance: In Theory and Practice* (OUP 2008); Stephen Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' (2003) 97 *Northwestern University Law Review* 546, 549.

governance is better described by the notion of director primacy, while the UK follows the shareholder primacy model.[9]

The core tenet of US corporate governance is its trust in directors and the limited role for shareholders. 'Shareholders exercise virtually no control over either day-to-day operations or long-term policy'.[10] The board of directors is vested with managerial power to make the vast majority of corporate decisions. As Bainbridge argues, 'corporation law virtually carves the separation of ownership and control into stone'.[11] Likewise, Delaware's traditional approach to companies has been described by the leading judges of the Delaware Court as follows:

> 'The notion that stockholders should have the power to disrupt the functioning of the republic whenever they see fit is viewed as fundamentally inconsistent with the Delaware model of the corporation … [T]he election of directors is the one area in which stockholders may act affirmatively … [T]he normative appeal of this analogy to republican democracy is limited, however, by the realities of the corporate election process. One fundamental reality is that the annual election process is tilted heavily towards management and does not operate in a way that encourages genuine choice or debate.'[12]

Shareholder participatory rights are considered so weak that 'they scarcely qualify as part of corporate governance'.[13]

Legal constraints that prevent shareholders from exercising control and influence over the board and management are supplemented by economic factors. Shareholder activism is generally assumed to be prohibitively expensive for shareholders because any benefit flowing from activism will be equally shared amongst shareholders, while the cost is borne by the activist shareholder. In other words, shareholders are generally assumed to be 'rationally pathetic' or 'rationally

[9] Christopher Bruner, *Corporate Governance in the Common-Law World: The Political Foundations of Shareholder Power* (CUP 2013); John Armour and Joseph McCahery, 'Introduction' in John Armour and Joseph McCahery (eds.), *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Hart Publishing 2006) 13; Lynn Stout, *The Shareholder Value Myth* (Berrett-Koehler Publishers 2012) 56; Sofie Cools, 'The Real Difference between the US and Continental Europe: Distribution of Powers' (2005) 30 *Delaware Journal of Corporate Law* 697 .
[10] Bainbridge (n 7) 46.
[11] Stephen Bainbridge, *The New Corporate Governance in Theory and Practice* (n 8) 4.
[12] William Allen, Jack Jacobs and Leo Strine, 'The Great Takeover Debate : A Meditation on Bridging the Conceptual Divide' (2002) 69 *The University of Chicago Law Review* 1067, 1094.
[13] Bainbridge 'The Means and Ends of Corporate Governance' (n 8) 569.

passive' because of collective action and free-rider problems.[14] The limited shareholder influence over corporate decision-making is often thought to be the way it ought to be,[15] given the economic efficiency of a centralised decision-making body that has power to act by fiat.[16]

As with all powers, directors and managers could exercise power inefficiently or to advance their own private interests. The separation of ownership and control gives rise to significant agency and accountability problems in public companies.[17] Under agency cost theory, directors and managers are the agents of shareholders (principals) and manage companies on behalf of shareholders. As a result, ensuring the accountability of directors[18] and addressing the agency problems became the primary concerns of company law.[19]

In ensuring accountability in companies, director primacy relies heavily on the market for corporate control. Under the market for corporate control, it is usually assumed that dissatisfied shareholders exercise monitoring function by selling shares, thereby leading to a decrease in the share price of the company and making hostile takeovers possible.[20] It is argued that the market for corporate control encourages managers to act 'as if they have the shareholders' interests at heart'.[21] Exit, i.e. the 'Wall Street Walk', is regarded as a more effective way to express dissatisfaction with the management and to address accountability concerns within the corporation. The

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[14] Adolf Berle and Gardiner Means *The Modern Corporation and Private Property* (Transaction Publishers 2009); Frank Easterbrook and Daniel Fischel *The Economic Structure of Corporate Law* (Harvard University Press 1991) 65-8.
[15] Jennifer Hill, 'Visions and Revisions of the Shareholder' (2000) 48 *The American Journal of Comparative Law* 39, 57.
[16] Bainbridge, *The New Corporate Governance: In Theory and Practice* (n 8) 38-53.
[17] Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.
[18] Iris Chiu, *The Foundations and Anatomy of Shareholder Activism* (Hart 2010) 22.
[19] Klaus Hopt, 'Comparative Company Law' in Mathias Reimann and Reinhard Zimmermann (eds) *The Oxford Handbook of Comparative Law* (OUP 2006), 1180-86; Gordon Smith, 'Corporate Governance and Managerial Incompetence: Lessons from Kmart' (1996) 74 *North Carolina Law Review* 1059, 1054; John Armour, Henry, Henry Hansmann, and Reiner Kraakman, 'Agency Problems and Legal Strategies' in Reiner Kraakman et al., (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2017) 29.
[20] See, Henry Butler, 'The Contractual Theory of the Corporation' (1989) 11 *George Mason University Law Review* 99, 111; There are also other types of the discipline of the market. See Chapter 2.
[21] Butler (n 20) 122.

market for corporate control has also found its place in court decisions: '[t]he redress for failures that arise from faithful management must come from the markets …'[22] In addition, director primacy theory relies on the dynamics of the boardroom, the corporate hierarchy in monitoring managers and directors themselves, independent directors, and remuneration contracts.[23]

History, however, has shown a great number of corporate governance scandals caused by the failure of these accountability mechanisms. A lack of efficient control mechanisms could incentivise shirking, extracting value from companies or to taking excessive risks for lavish salaries. In the Enron, WorldCom and Tyco fiascos, auditors failed to detect the irregularities in financial statements of companies because of the compensation structures of audit firms.[24] In addition to the failure of the auditors, the Enron board, regarded as one of the best boards of a publicly held company, failed to monitor fraudulent transactions of managers leading to the company's collapse due to its overreliance on the management.[25] In the 2007-2008 financial crisis, the board of Citigroup faced serious allegations that directors failed to oversee the transactions of management despite the existence of 'red flags' that signalled potential problems in the way in which the company was managed.[26] Similarly, the board of directors at Lehman Brothers were dysfunctional and lacked the relevant expertise and knowledge to understand and to monitor the transactions undertaken by management.[27] The total cost of the 2007-2008 financial crisis was around $11.9 trillion.[28] These cases are good examples of the costs of failure of accountability mechanisms, and also show that centralised management by a board does not always result in the most efficient type

[22] *In re The Walt Disney Company Derivative Litigation* 907 A.2d 693 (Del.Ch., 2005).
[23] Bainbridge, (n 7) 51.
[24] John Coffee, 'What Caused Enron – A Capsule Social and Economic History of the 1990s' (2004) 89 *Cornell Law Review* 272.
[25] Bernard Sharfman and Steven Toll, 'Dysfunctional Deference and Board Composition: Lessons From Enron' (2008) 103 *Northwestern University Law Review Colloquy* 153.
[26] See, *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A. 2d 106 (Del. Ch. 2009).
[27] Grant Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis' (2009) 2009(1) *Financial Market Trends* 21-2.
[28] William Sun, Jim Stewart, and David Pollard (eds) *Corporate Governance a nd The Global Financial Crisis: International Perspectives*, (Cambridge University Press, 2011), 2.

of management. It also demonstrates that the board may fail to carry out its expected role under director primacy system of corporate governance.

Institutional shareholders were not regarded as having capacity to monitor the board and management and to participate in the decision-making processes of public companies. A major impediment to shareholder activism is that it is not an easy option for them because of legal and regulatory obstacles and the problem of collective action and free-riding. There have been promising developments in the global economy and the markets that have reshaped the incentives of shareholders,[29] and improved the means of communication, technology and trading patterns.[30] These developments have made activism more likely than ever before. The foremost development was the transformation of share ownership of listed companies from individual to institutional ownership.[31] In particular, private savings for the long term such as pensions played a pivotal role in the emergence of the privately-managed investment industry. The assets under management of the investment industry reached $36.1 trillion in 2015.[32] The economic growth of the investment industry is an indication of the socio-economic importance of institutional investment in the economy and society. In addition to the traditional institutional investors, activist funds have emerged and begun to engage in high profile activism.[33] The changing tactics of activist funds have mobilised traditionally passive institutional shareholders.

In the post-financial crisis era, shareholders are perceived as being able to exercise monitoring over the management of portfolio companies in a way which generates overall social benefit and also addresses accountability concerns in the corporate sector. The Financial Reporting Council (FRC) in the UK issued the

[29] Ronald Gilson and Jeffrey Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and The Revaluation of Governance Rights' (2013) 113 *Columbia Law Review* 863.
[30] Brian Cheffins and John Armour, 'The Past, Present and Future of Shareholder Activism by Hedge Funds' (2011) 37 *The Journal of Corporation Law* 52, 72.
[31] See Brian Cheffins and Steven Bank, 'Is Berle and Means Really a Myth?' (2009) 83 *Business History Review* 443.
[32] The Boston Consulting Group, 'Global Asset Management' (2016) http://www.agefi.fr/sites/agefi.fr/files/fichiers/2016/07/bcg-doubling-down-on-data-july-2016_tcm80-2113701.pdf accessed 19 June 2017.
[33] Dionysia Katelouzou, 'Myths and Realities of Hedge Fund Activism: Some Empirical Evidence' (2013) 7 *Virginia Law & Business Review* 459.

'Stewardship Code' (SC), which requires institutional shareholders to engage with their investee companies.[34] A stewardship movement has also emerged in the US, [35] but as a result of bottom-up market forces. In practice, this movement seeks to firm up shareholder behaviour to facilitate long-term investment and to control short-termism and pressures from activist funds. Active monitoring can be an accountability mechanism that protects and promotes shareholders' own interests, and acts as a proxy for protecting and promoting the long-term interests of the company and economy as a whole.

The final challenge is that even if shareholder activism is possible, it could arguably have a negative impact on the decision-making processes of companies, cause short-termism at the expense of the long-term interest of companies and other stakeholders, and lead to the extraction of private benefits from the company.[36] This anti-shareholder empowerment rhetoric has dominated the US literature and law-making process.[37] Even in the post-Enron era, lawmakers have sought to enhance shareholder protection rather than shareholder participation.[38] However, the 2007-2008 financial crisis has triggered legal and regulatory reforms to empower shareholders to ensure the accountability of directors and the financial stability of markets.[39]

1.2 Objectives of the Research

Given the recent developments in corporate governance, the possibility of changes in the field, and tensions between director primacy and increasing shareholder activism, this thesis contributes to the recurring theme of the allocation of power between

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[34] FRC, *The UK Stewardship Code* (Revised 2012). The Code aims to 'promote the long term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole'.

[35] Investor Stewardship Group, 'The Stewardship Principles' https://www.isgframework.org/stewardship-principles/.

[36] See Chapter 3; Lynn Stout, *The Shareholder Value Myth* (Kindle Ed., Berret-Koehler Publishers 2012); Martin Lipton and Steven Rosemblum, 'Election Contests in the Company`s Proxy An Idea Whose Time Has not Come' (2003) 59 *The Business Lawyer* 67; Stephen Bainbridge, 'The Case for Limited Voting Rights' (2006) 53 *UCLA Law Review* 601.

[37] See Chapter 3 and 5.

[38] The aim of the Sarbanes-Oxley Act is 'to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes'. Sarbanes-Oxley Act of 2002, Pub. L. No 107-204, 116 Stat. 745 (2002).

[39] The Preamble of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

shareholders and directors in public companies by exploring the theoretical foundations, legal changes and future development of shareholder power in the US context. The emerging investor paradigm requires us to consider properly the context in which the activist funds and the awakening mainstream institutional investors are placed. However, it is not clear how this can fit into the US corporate governance model which generally does not welcome shareholder participation in the management of companies. This study will contain an analysis of the director-orientated rules and doctrines accepted by the courts, as well as the legal and regulatory reform suggestions in company law in order to speculate on the way forward for the US. Taking into account the tension between shareholders, the board and managers, the following research question will be examined in detail:

a- Should the current director primacy theory be softened to accommodate the developing role of shareholders in US corporate governance?

In answering the core research question, there are additional questions that need to be answered:

b- What is the role of shareholders under contractarian and director primacy theories? To what extent could directors and managers be held accountable within the boundaries of contractarian and director primacy theories?
c- Is the evolving role of shareholder activism desirable, given the potential problems that shareholder activism might cause in corporate governance?
d- What are the features and types of institutional investors?
e- To what extent is shareholder activism practicable (i) in US company law and (ii) with the context of the judicial interpretation of director primacy in the US?
f- Are the concepts of authority and accountability compatible? Are there any legal reforms which would enhance the functioning of shareholder activism while providing sufficient room for directors?

It adopts both positive and normative approaches. First, it contributes to the knowledge of how different types of shareholder activism have taken place in the market, and how institutional shareholders interact with other institutions of corporate governance and features of the monitoring environment. Second, in normative terms, it seeks to justify and pinpoint, the ways in which shareholder activism can be enhanced as an accountability mechanism.

These questions will be answered in the context of corporate governance in public companies in the US, since shareholder activism in privately-held companies would require consideration of other issues,[40] and deserve a separate discussion. The research will also confine its discussion of shareholder activism to activism among institutional shareholders, since they are the major owners of the shares of public companies, and individual shareholders are often too dispersed and unmotivated to engage in activism. Therefore, the activities of individual shareholders will not be discussed in this thesis.

US law has been chosen as the focus for this research owing to its unique approach to the role of shareholders in corporate governance. It is also valuable in company law studies and has a strong influence on other jurisdictions. In the US, there are 51 state jurisdictions which can be chosen as a formal domicile for a company.[41] As such, it is impossible to examine all of these jurisdictions in a single thesis. Therefore, Delaware was chosen as a proxy since its leading position as the preferred state of incorporation is beyond dispute.[42]

1.3 Original Contribution to the Field

In recent years, a considerable corpus of material on shareholder activism or the role of shareholders has been published. Yet a lot of diversity exists in the literature as each scholar approaches shareholder activism from their own unique perspective. It is therefore impossible to provide an all-encompassing literature review. However, it is useful to examine how key arguments have been discussed in the literature in order to

[40] In the privately-held companies, the separation of ownership and control is almost fictional. In these companies, major shareholders are often also directors and managers. Shareholder-managers could ignore the interests of companies and other shareholders in performing managerial activities. It is also possible that major shareholders could obtain private benefits from companies and other shareholders. Hence, the privately-held companies have different internal dynamics and face different corporate governance problems than public companies. See, Howard Friedman, *Publicly Held Corporations* (OUP 2011) 3; Mark Roe, 'The Institutions of Corporate Governance' in Claude Ménard and Mary Shirley (eds), *Handbook of New Institutional Economics* (Springer 2008) 371.

[41] Marc Moore, *Corporate Governance in the Shadow of the State* (Hart 2013) 106.

[42] Lucian Bebchuk and Alma Cohen, 'Firm's Decision Where to Incorporate' (2003) 46 *Journal of Law and Economy* 383.

demonstrate how this thesis develops its own position. This thesis adds value to the literature by examining how the emerging shareholder and board relationship in the US could affect the current incarnation of the director primacy theory applicable in the US. Issues around the allocation of power have been examined from competing theories and the discussion primarily revolves around who should have the ultimate power in companies. However, their consideration remains limited in the context of the market and policy developments regarding institutional shareholders. This thesis, therefore, brings new perspectives that challenge inherent assumptions in the literature, and also makes a number of timely contributions to the existing body of knowledge regarding the role of shareholders in US corporate governance in the post-crisis era.

Bainbridge is a pioneer in the legal literature on director primacy theory with a large number of publications on the topic.[43] Centralised management with authority is of survival value to public companies because it lowers costs relating to uncertainty and opportunism and delivers the benefits of specialised and informed management. Directors have clear decision-making advantages compared to shareholders with varying interests and levels of information. The core claim of this theory is that companies are managed most efficiently when the authority is centralised as much as possible in the hands of a board of directors. The centralised authority provides a level of efficiency that could not be achieved by shareholder decision-making in large companies. This theory assumes that the board has capacity to carry out a unique combination of 'advice giving, on-going supervision, and crisis management.'[44] In director primacy theory, shareholder activism is incompatible with the centralised authority of the board because of the inherent trade-off between authority and accountability. Therefore, 'one must not lightly interfere with management or the board's decision-making authority in the name of accountability'.[45] Therefore, shareholder participation in decision-making means a reduction in authority for the

[43] Bainbridge (n 8); Stephen Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2005) 119 *Harvard Law Review* 1735; Stephen Bainbridge, 'Unocal at 20: Director Primacy in Corporate Takeovers' (2006) 31 *Delaware Journal of Corporate Law* 769.
[44] Bainbridge (n 8) 161.
[45] Bainbridge, *The New Corporate Governance: In Theory and Practice* (n 8) 113.

board which is counterproductive. Since shareholder activism is inefficient, the adherents to director primacy do not anticipate demanding a greater participatory role.[46] The proponents of different versions of director primacy theory argue that shareholder activism causes short-termism in corporate governance and forces companies to follow risky business strategies at the expense of other stakeholders.[47] Some scholars also place emphasis on self-interested actions of shareholders and intra-shareholder conflicts which may occur where a group of shareholders follow their own interests.[48] Thus, shareholder activism is considered a potential threat to the efficient functioning of public companies. In addressing accountability problems, this theory relies on board dynamics, the market for corporate control and other corporate control mechanisms, viz. non-executive directors, remuneration contracts, and auditors monitoring directors and managers. However, while this thesis fully acknowledges the economic efficiency of the centralised management with authority model, some of its arguments are challenged.

In this regard, this thesis highlights that these corporate control mechanisms are subject to inherent limitations as they fail to monitor directors and managers and mitigate their inefficiency and ineffectiveness. Moreover, the board often fails to carry out this unique role and exercise adequate oversight of management to prevent manager-induced failures because of the de facto power of management in the decision-making process of large companies. Independent directors of course increase the monitoring capacity of the board, but they are not substantively independent of management because they are dependent on it for information and resources. The board's capacity to carry out such a unique role is not fully adequate. The failures of Enron and Lehman Brothers are typical examples of how the boards could fail to monitor management effectively.[49] When they fail adequately to exercise their roles,

[46] Richard Buxbaum, 'Corporate Legitimacy, Economic Theory, and Legal Doctrine,' (1984) 45 *Ohio State Law Journal* 515, 526 (describes the evolution of shareholders to investors in the market); Henry Manne, 'Our Two Corporation Systems: Law and Economics' (1967) 53 *Virginia Law Review* 259, 260-1.
[47] see fn. 36.
[48] see Chapter 3.
[49] For instance, the independent board of directors at Lehman Brothers was dysfunctional in the wake of the financial crisis. Members of the board satisfied the independence requirements of the New York Stock Exchange, but they did not have sufficient knowledge or skills to understand complexities that

failure could have a massive negative impact on the market. In addition, US company law provides strong protection to directors who underperform, pursue controversial business strategies or fail to monitor managers; hence, the duty of care is almost irrelevant to US public companies. The law does not provide sufficient deterrence for inefficient and ineffective directors and managers. In consideration of the importance of accountability of directors and managers in the interests of shareholders and companies, this thesis illustrates how the web of accountability mechanisms possess limited capacity to prevent directors and managers from shirking or engaging in rent-seeking behaviour. Hence, there is a need for better functioning corporate governance, which addresses accountability problems more effectively than the current state of model and enhances decision-making processes of public companies.

In order to address accountability problems in public companies, shareholder primacy theory attributes a greater role to shareholders. 'Shareholder primacy contends not only that shareholders are the principals on whose behalf corporate governance is organised, but also that shareholders do (and should) exercise ultimate control of the corporate enterprise'.[50] Since shareholders are residual claimants and principals, they are deemed to have the right, interest and incentive to make efficient decisions; therefore, they should have ultimate control.[51] Shareholder empowerment is therefore an important tool to deal with agency problems. Bebchuk played a pivotal role in the shareholder empowerment debate and called for greater power for shareholders.[52] This line of debate relies on the role of shareholder empowerment in increasing the efficiency of companies rather than any concern for the intrinsic value

company undertook in the market. See, David Larcker and Brian Tayan, 'Lehman Brothers: Peeking under the Board Facade' (4 June 2010) *Stanford Closer Look Series;* see also Bernard Sharfman and Steven Toll, 'Dysfunctional Deference and Board Composition: Lessons From Enron' (2008) 103 *Northwestern University Law Review Colloquy* 153.

[50] Bainbridge, 'The Means and Ends of Corporate Governance' (n 8), 563.

[51] Henry Hansmann and Reiner Kraakman, 'The End of History for Corporate Law' (2001) 89 *The Georgetown Law Journal* 439, 441.

[52] Lucian Bebchuk, 'The Myth of the Shareholder Franchise' (2007) 93 *Virginia Law Review* 675; Luician Bebchuk, 'Letting Shareholders Set the Rules' (2005) 119 *Harvard Law Review* 1784; Lucian Bebchuk, 'The Myth That Insulating Boards Serves Longterm Value' (2013) 113 *Columbia Law Review* 1637; see also, George Dent, 'The Essential Unity of Shareholders and the Myth of Investor Short-Termism' (2010) 35 Delaware *Journal of Corporate Law* 97.

of shareholder democracy.[53] Bebchuk, who is the leading scholar for shareholder empowerment, proposed to grant decision-making powers to shareholders to amend charters, to change the state of incorporation, and to initiate business decisions of substantial importance.[54] The proponents of shareholder primacy theory highlight that shareholders have insufficient power, and establish a link between shareholder empowerment and the financial performance of companies. However, they little about how shareholder activism can function to improve corporate performance.[55] The challenge for the proponents of shareholder empowerment is the measurement of the efficiency of empowerment, an area on which much ink has been spilt.[56] As will be seen throughout the thesis, the empirical evidence is inconclusive and can be challenged.[57] Therefore, it cannot provide sufficient theoretical and empirical support for the role of shareholders in corporate governance.

1.3.1 The Desirability of Shareholder Activism from the Perspective of the *Exit, Voice, and Loyalty* framework

Since the empirical evidence is inconclusive, the desirability of shareholder activism cannot be adequately determined on that basis alone. To explore the role of shareholder activism fully and how it functions, this thesis engages with Hirschman's influential book *Exit, Voice, and Loyalty: Responses to Decline in Firms,*

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[53] Bebchuk, 'The Myth of the Shareholder Franchise' (n 52) 678.

[54] See, Lucian Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 *Harvard Law Review* 833.

[55] See for a similar criticism, Robert Thompson and Paul Edelman, 'Corporate Voting' (2009) 62(1) *Vanderbilt Law Review* 129, 145.

[56] Roberta Romano, 'Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance' (2001) 18 *Yale Journal on Regulation* 174, 176-7; Bernard Black, 'Shareholder Activism and Corporate Governance in the United States' (1998) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=45100 accessed 10 May 2017; see for a literature review of empirical studies on shareholder activism, Stuart Gillan and Laura Starks, 'The Evolution of Shareholder Activism in the United Stated' (2007) 19(1) *Journal of Applied Corporate Finance* 55, 60-61 (Gillan and Starks examined 39 empirical studies on shareholder activism, and show that study results are mixed); Zohar Goshen and Richard Squire, 'Principal Cost: A New Theory for Corporate Law and Governance' (2017) 117 *Columbia Law Review* 767 section IV.A.

[57] See note 56; John Coffee, and Darius Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2016) 1 *Annals of Corporate Governance* 1; see for another challenges in the past, Lynn Stout, 'The Mythical Benefits of Shareholder Control' (2007) 93 *Virginia Law Review* 789, 798–99 (finds weak evidence for greater shareholder franchise); see for the relevant literature on the lack of any consistent relationship between shareholder empowerment and overall financial performance. Zohar Goshen and Richard Squire, 'Principal Cost: A New Theory for Corporate Law and Governance' (2017) 117 *Columbia Law Review* 767 section IV.A.

Organisations, and States,[58] which considers voice to be a feedback mechanism. In principle, shareholder activism functions as a feedback mechanism and alerts the management of a particular organisation about the underperformance of the organisation, while exit alerts the management through market.[59] Shareholder activism is an attempt to change the policies of an organisation, through petition or other means to management directly in charge or through appeal to a higher authority.[60] Therefore, voice i.e. shareholder activism is strongly related to political behaviour.[61] Voice allows shareholders to correct the egregious failures of the board and management before it is too late. Shareholder activism direct the board toward a policy with the lowest agency cost problems. Each company derives diverse benefits from activism, depending on its features. For instance, a company operating in a competitive market may benefit from immediate responses from the market. Therefore, short-term responses of shareholders could be beneficial for some companies. However, it might be destructive for another company. In other words, voice could be excessive for a particular organisation as well.[62] Overall, shareholder activism functions as a feedback mechanism and has a firm-specific nature.

1.3.2 A More Complete Framework for Shareholder Activism

In the post-crisis era, shareholder activism is blamed for injecting short-termism in corporate governance and destroying the long-term interests of public companies.[63] However, such criticism fails to reflect contemporary shareholder activism because there is no single type of shareholder activism. In order to tackle this problem, this thesis considers shareholder activism as a collection of different types of shareholder activism, that differ by objectives, methods, and motives.[64] In this respect, it provides an alternative and better positive theory how shareholder activism functions and interact with the board and management. Hence, with the help of this complete framework, we can draw coherent and consistent normative conclusions regarding the

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[58] Albert Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States* (Harvard University Press 1970).
[59] Hirschman (n 58), 30.
[60] Hirschman (n 58), 30.
[61] Hirschman (n 58), 15-6.
[62] Hirschman (n 58), 70.
[63] See note 36.
[64] See Chapter 4.

allocation of power between directors and shareholders. This framework avoids us from being trapped in the polar characterisation of shareholders by the proponents of director primacy and shareholder primacy theories. Shareholder activism could be related to financial issues as well as those of non-financial issues such as environmental, social and governance nature. The different groups of institutional shareholders serve different functions in corporate governance. In this context, activist investors reveal the flaws of corporate strategies mostly from the performance of financial performance. Some mainstream investors are informed voters and are willing to support activist proposals if they believe activist proposals are likely to increase shareholder value. On 31 January 2017, major mainstream institutional shareholders published the Stewardship Principles and developed a new paradigm.[65] These investors facilitate direct engagement with the board and are willing to contribute to the development of business strategies for long-term value creation rather than immediate share price increases. ESG (environmental, social and governance), and CSR (corporate social responsibility) issues are important for these investors. These mainstream investors show that there could be a middle ground between shareholder primacy and board primacy theories because the way in which they exercise shareholder activism is more collaborative than is assumed by these theories. This type of activism is a new paradigm in the US and could reshape the relationship between the board and shareholders.[66] There are also other funds which primarily focus on social performance, even though this type of activism may not bring about an immediate increase in share prices.[67] Overall, shareholder activism can enrich the board by providing feedback to the board and plays an error correction role by warning the board and management about the underperformance of the company.

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[65] Martin Lipton, 'The New Paradigm for Corporate Governance' (*HLSFCGF*, 3 February 2016) < https://corpgov.law.harvard.edu/2016/02/03/the-new-paradigm-for-corporate-governance/ > accessed 20 February 2016.

[66] See Chapter 3.

[67] See Chapter 3; See for the insignificant impact of governance activism, Roberta Romano, 'Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance' (2001) 18 *Yale Journal on Regulation* 174; see Vincente Cuñat, Mireia Giné, and Maria Guadalupe, 'The Vote is Cast: The Effect of Corporate Governance on Shareholder Value' (2012) 67 *Journal of Finance* 1943, 1954 (this paper finds a positive impact on shareholder value).

1.3.3 The Softer Version of Director Primacy Theory is Possible

Such analytical framework indicates that shareholder activism could function without undermining the value of the board authority.[68] In contrast to director primacy theory, this thesis considers accountability and authority to be mutually consistent. In other words, it finds the board authority compatible with shareholder participation, in contrast to the traditional director primacy theory. Therefore, it challenges the precept of a trade-off between authority and accountability. In this respect, there is no arithmetic allocation of power (authority) between the board and shareholders; thus, board authority is compatible with strong shareholder participatory rights. Hence, the fundamental policy question of corporate governance should be how accountability problems could be mitigated while preserving sufficient room for the board and management, instead of discussing quanta of power and the holder of ultimate power.[69]

Traditional director primacy theory, therefore, could be rendered more flexible to accommodate the evolving role of institutional shareholders in corporate governance, without undermining board authority. Since traditional director primacy theory considers shareholder activism inherently detrimental to the functioning of corporations, it argues that company law should attribute very restricted role for shareholders and that companies are managed most efficiently when authority is centralised in the hands of the board. It relies on that the board has capacity to monitor managers and directors and to carry out managerial tasks. However, the board could fail to carry out the expected roles because of its overreliance on management, the close relationship with management, and the lack of sufficient information and knowledge. At this point, it becomes evident how the evolving role of shareholders might be useful to US corporate governance: it could enhance the board's capacity to carry out its unique role, reduce agency and accountability problems, and enhance the sustainability of companies.[70] In this regard, this thesis argues that the current director primacy theory should not survive in its extreme form. It should be softened to accommodate the evolving role of shareholders in US corporate governance.[71]

[68] See Chapter 3 and 6.
[69] See Chapter 6.
[70] See Chapter 6.
[71] See Chapter 6

This thesis argues that the softer version of director primacy is possible. The evolving role of shareholders makes the softer version of director primacy theory possible because shareholder activism serves as an error correction role rather than the exercise of authority.[72] The softer version of director primacy does not deny the value of board authority and vests the board of directors with the ultimate power to manage; however, shareholders are given a space at the corporate discussion table. This new approach provides this space by enhancing shareholder power and increasing the effective use of shareholder rights. The shareholder voice will thus be heard in the decision-making processes of public companies and cannot be ignored by managements and boards. By increasing shareholder voice in the corporate governance, this new model enhances the board's capacity to carry out its unique dual role by making the board less dependent on management. Activist shareholders can enrich the board with new information and raise legitimate questions about the current practices and business strategies of the management. Where the board receives robust criticism regarding a management strategy, it will be forced to be more critical and to obtain more information about the management strategy, which is a prerequisite for a well-functioning director primacy model. The board must also provide an account to other shareholders for that particular strategy, lest, activist shareholders could convince other shareholders and escalate activism to the extent that they could replace the board members. As a result, the board has to have deep knowledge of company and be appropriately critical of management to convince other shareholders to support it and the existing corporate governance practices. Such informed directors could provide more effective monitoring of managerial performance and, where needed, provide a managerial role in establishing major corporate governance and business planning issues.

In this respect, the board's capacity to carry out its unique role (managerial and monitoring roles) will be higher under the softer version of director primacy theory, compared to the traditional director primacy theory. Since the softer version of director primacy incorporates the role of shareholders into the functioning of public companies, it could address agency and accountability problems more effectively than

[72] See Chapter 6.

traditional director primacy and has an enhanced decision-making process over traditional director primacy. The inclusion of the evolving role of shareholder activism in the functioning of public companies reduces the board's overreliance on management, which in turn completes the deficiencies of the board. The softer version of director primacy also allows the board to address the opportunism of activist funds by fine-tuning shareholder authority with the help of mainstream investors. It also acknowledges the value of the board of directors in public companies. Even in the soft director primacy model, it will be shown that a power imbalance between shareholders and directors persists.

This thesis also shows that there have been positive developments in terms of shareholder activism in the market. Institutional shareholders are becoming more active and making seismic changes in US corporate governance on a company-by-company basis. The increased shareholder activism also challenges the assumptions of contractarian theory i.e. the rational shareholder apathy. Therefore, corporate governance should not be built on the assumptions that shareholders are rationally passive or are short-term investors, given the evolving role of shareholders in the US. In the market, the softer version of director primacy theory is gradually emerging with the help of institutional shareholders.[73] Institutional shareholders create a difference between corporate governance in books and corporate governance in the market.[74] Corporate governance in the market is diverging from the extreme form of director primacy and establishes the middle ground between director primacy and shareholder primacy theories. However, these developments are still not sufficient to recognise the value of shareholder activism. This thesis recommends that the law should follow the developments in the market. Hence, it makes several recommendations: creating a level playing field for private orderings and adopting the default proxy access rule, majority voting rule, and universal proxy cards.

[73] See Chapter 3.
[74] See Chapter 5.

1.3.4 The Side Effects of Activist Funds Should Be Addressed for a Better Functioning Corporate Governance

In the literature, some scholars consider that activist funds could bridge the gap between ownership and control in public companies.[75] However, they overlook the side effects of activist funds. This research also explores the side effects of shareholder activism. Even though this thesis is of the view that the side effects of shareholder activism should not be overemphasised, it recognises two possibilities, unlike many proponents of shareholder empowerment.[76] First, that activist funds might occasionally increase their influence to force the board to make particular business decisions that advance their own interest rather than the board's and other shareholders'; and second, shareholder activism could be excessive, and thereby disruptive for some companies. In this respect, this thesis will investigate and discuss legal and regulatory means that seek to minimise these negative aspects of shareholder activism. It suggests increasing the disclosures requirement of shareholders to curb the side effects of activist funds.

1.4 Methodology

This thesis adopts the doctrinal research methodology which relies on primary and secondary resources, including law, cases, books, articles, empirical studies, corporate governance forums, opinions of institutions, and newspapers. These primary and secondary sources focus on shareholder activism in the US and UK. The research synthesises different ideas and develops new thoughts on how the evolving role of shareholders described above could be accommodated within the framework of director primacy model.

This thesis primarily focuses on US company law and analyses the cumulative impact of US law and regulation on shareholder participation in the management of companies. Therefore, it does not adopt a comparative research methodology. Yet some aspects of UK law and corporate governance are also considered where relevant.

[75] Gilson and Gordon (n 29); Bebchuk (n 54); Yaron Nili, 'Missing the Forest for the Trees: A New Approach to Shareholder Activism' (2014) 4 *Harvard Business Law Review* 158; Lucian Bebchuk and Robert Jackson 'The Law and Economics of Blockholder Disclosure' (2012) 2 *Harvard Business Law Review* 39.

[76] See Chapter 3.

The references to UK corporate governance and cases pertaining to UK law are made for a number of reasons. First of all, although these countries adopt two different approaches in their corporate governance models, public companies in both countries share structures that are similar. They also belong to the same legal family. Second, the UK is among the most shareholder friendly jurisdictions in the world, with the references to UK law allowing us to better understand how US law is director-centric. Third, shareholder participation has been uncontroversial in the UK for a long time;[77] therefore, the related literature, corporate governance codes, and reports could provide guidance on how board authority could function with strong participatory rights. For these reasons, relevant literature on the UK will be taken into consideration.

Doctrinal research by itself is not sufficient to examine the role of shareholders in corporate governance because the financial incentives of shareholders is one of the main drivers behind shareholder activism. Therefore, this thesis uses concepts and ideas from a law and economics approach. Within this approach, concepts such as efficiency, cost-benefit analysis, and collective action and free-rider problems have played a dominant role in assessing the desirability of any legal reform and the roles of shareholders and directors. This thesis attempts to evaluate the impact of the transformation from individual share ownership to institutional share ownership on the cost-benefit analysis of activism. Additionally, factors affecting the business model of institutional shareholders are examined to highlight that the cost-benefit analysis is by itself insufficient to understand contemporary shareholder activism.

The law and economics approach perfectly explains why shareholders prefer to exit rather than voice their concerns about management. This line of thought considers exit as far more efficient and rational for shareholders. Success and failure are evaluated through share prices, and any disciplining of directors and managers comes from the market. It is an easy option for shareholders because it does not require any further action. However, shareholder activism has a political character and is not necessarily related to the financial incentives of institutional shareholders. There are many motives behind shareholder activism, which are not limited to the financial incentives of shareholders, i.e. the cost-benefit analysis. This thesis brings

[77] Moore (n 41) 187.

Hirschman's framework into the corporate governance domain as a complement to the legal and economic approach rather than as a replacement. It highlights aspects of shareholder activism, in addition to those cost-benefit analyses. In Hirschman's framework, shareholder activism, i.e. voice, is the articulation of critical opinion between shareholders and directors. In order to analyse the changing role of shareholder activism and its implications for director primacy theory, Hirschman's framework is needed in order to complements to legal and economic approach. It provides a more robust theoretical underpinning.

1.5 Structure of the Thesis

This thesis is structured around the key research questions set out in the previous section. In the following section, a brief overview of each chapter is presented.

Following this introduction, Chapter 2 lays down the theoretical framework by explaining corporate governance. The insider and outsider models are broadly introduced with an emphasis on the core feature of the outsider model, namely the separation of ownership and control. It explains the inevitable consequences of the separation of ownership and control: passive and weak shareholders and unaccountable directors. It moves on to analyse the prevailing theory of the firm, namely the contractarian theory, and director primacy theory. It examines why shareholders are the only constituents given voting rights, and why shareholder participation is limited, given the agency costs in the firms. Subsequently, the chapter analyses the shareholder primacy theory which argues that shareholders should be the ultimate controllers in firms. In the final section of Chapter 2, alternative accountability mechanisms are examined, viz. the market for corporate control, executive remuneration, independent directors and the external audit in order to determine whether there is room for shareholder activism in ensuring accountability in firms.

Chapter 3 focuses on the nature and types of shareholder activism. It explains the differences between offensive and responsible shareholder activism, as well as how shareholder activism could be beneficial for shareholders in monitoring and disciplining the board and management. It then examines how shareholder activism is perceived as a means of addressing public interest concerns such as short-termism and attacks by activist funds, and to ensure long-termism in the market. Shareholder activism has a dual role: as a monitoring mechanism that protects and promotes the interests of all shareholders, and an accountability mechanism for ensuring the long-term sustainability of companies and economy through the concept of stewardship. The second part of Chapter 3 discusses the potential problems related to increased shareholder activism in order to decide whether there is a strong case for shareholder disempowerment.

Chapter 4 examines the transformation of the share ownership of listed companies from individual ownership to institutional ownership. It goes on to analyse the impact of increasing institutional ownership on shareholder activism and discusses whether free-rider and collective action problems could be overcome, and whether the benefits would exceed the costs of activism. It then seeks to answer why institutional investors do not exercise the same level and type of shareholder activism and exercise different types of activism.

Chapter 5 critically discusses the legal and governance practices which underlie director primacy theory in the US. This chapter evaluates the practicability of the changing role of shareholders in US company law. It firstly examines the structure of the board and how it evolved from an advisory to a monitoring board. It places emphasis on the information gap created by virtue of this transition, and the de facto power of managers arising from the delegation of power from directors to managers. It then examines the judicial deference to board authority through the business judgment rule. This analysis shows that courts rely on shareholder democracy, that is, they rely on shareholders and on the market for corporate control to discipline and replace under-performing managers. The second part of this chapter focusses on shareholder rights. It highlights the existence of limited participatory rights and the fact that the meaningful exercise of these rights can be problematic. Analysing the development of shareholder participatory rights reveals the tension between shareholders, corporate directors and managers. In its final section, Chapter 5 discusses whether recent legal and regulatory reform have heralded a paradigm change from director primacy to a more shareholder friendly model.

Chapter 6 ties the threads together by focusing on the evolving role of shareholders in the context of the recent market and policy developments to establish a framework that responds to the evolving role of shareholders, and to consider the legal and regulatory implications of this framework. This chapter offers a new approach as to whether the US model could incorporate shareholder activism while simultaneously preserving sufficient independence for directors. In doing so, it takes into account the potential collusion of activist funds without closing their business models. It then evaluates the UK model with a focus on the question of whether the board's authority is undermined in a shareholder friendly corporate governance model and discusses the role of statutory participatory rights. The final section of this chapter offers suggestions about improving the effectiveness of shareholder activism without altering underlying principles of US corporate governance.

Chapter 7 concludes this thesis by providing the key findings of chapters. This chapter addresses the research questions identified in the introduction. Additionally, the limitations of this research and the recommendation for future studies are also covered in the final chapter.

Chapter 2. Corporate Governance: Framework and Control Mechanism

2.1 Introduction

The purpose of this chapter is to examine the extent to which directors and managers can be held accountable within the boundaries of contractarian and director primacy theories, with a particular focus on the role of shareholders. As a foundation of this thesis, this chapter introduces the corporate governance theories and examines in-depth why shareholders are attributed a limited role in corporate governance from the perspectives of the contractarian and director primacy theories.

This chapter starts by reviewing the genesis and classification of corporate governance models. The well-accepted classification schema depends on the differences between the outsider and insider corporate governance models.[1] While shareholders in the insider model are concentrated and often have relationship with companies, shareholders in the outsider model are numerous and dispersed which results in a separation between ownership and control.[2] This separation creates so-called weak and passive shareholders. It raises significant accountability concerns in the outsider corporate governance model. This chapter moves to analyse key aspects of contractarian and director primacy theories[3], which conceive limited shareholder participation as the way things ought to be.[4] Under contraction theory, the firm is seen as a nexus of contracts that regulates the inputs offered by various parties to the production process in exchange for a corresponding output. All constituencies are contractual parties, but shareholders occupy a privileged position because of their

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[1] See, Christine Mallin, *Corporate Governance* (4th edition, OUP, 2013) Chapter 10; Ruth Aguilera and Gregory Jackson, 'The Cross-National Diversity of Corporate Governance: Dimensions and Determinants' (2003) 28 *Academy of Management Review* 447; Rafael La Porta et al., 'Corporate Ownership Around the World', (1999) 54 *Journal of Finance* 471.

[2] The insider and outsider models will be explained below in section 2.2. See also, Adolf Berle and Gardiner Means *The Modern Corporation and Private Property* (Transaction Publishers 2009).

[3] Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 67.

[4] Daniel Fischel, 'The Corporate Governance Movement' (1982) 35(6) *Vanderbilt Law Review* 1259; see Section 2.5.1 below.

contractual claims, i.e. residual claims, while other stakeholders have fixed claims.[5] In the contractarian theory, shareholders supply vital capital to the firm and delegate the managerial functions to managers, and managers provide their specialised decision-making skills to the firm. The agency cost theory analyses this relationship from a principal-agent perspective and places an emphasis on agency problems.[6]

In this regard, contractarian theory led to the emergence of two competing views as to the internal structure of companies and the allocation of power between shareholders and directors: director primacy theory and shareholder primacy theory; hence, this chapter analyses the theoretical aspects of both of the director and shareholder primacy theories. Shareholder primacy theory relies heavily on the concept of agency cost problems and argues that shareholders should be the ultimate monitor of the company.[7] By contrast, director primacy theory features the efficiency of centralised decision-making and finds authority and accountability mutually incompatible. It argues that shareholder participation is unnecessary and value decreasing where there are strong corporate control mechanisms, namely the market for corporate control, executive remuneration, audit and the role of non-executive directors.[8] The last section of this chapter outlines and critically examines the existing corporate governance mechanisms and whether they function adequately in ensuring managerial accountability in corporate governance.

2.2 Classifications of Corporate Governance Models Worldwide: the Insider and Outsider Corporate Governance Models

The origins of governance debates go back many centuries, but the term 'corporate governance' has been in use only since the 1970s.[9] Following corporate collapses in

[5] Jonathan Macey, 'Fiduciary Duties as Residual Claims: Obligations to Non-shareholder Constituencies from a Theory of the Firm Perspective' (1999) 84 *Cornell Law Journal* 1266, 1274

[6] Michael Jensen and William Meckling, 'Theory of the firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305.

[7] Henry Hansmann and Reiner Kraakman, 'The End of History for Corporate Law' (2001) 89 *The Georgetown Law Journal* 439, 440.

[8] See, Stephen Bainbridge, 'Director Primacy The Means and Ends of Corporate Governance' (2003) 97 *Northwestern University Law Review* 547.

[9] Norman Veasey, 'The Emergence of Corporate Governance as a New Legal Discipline', (1993) 48 *Business Lawyer* 1267.

the 1980s, it has gained contemporary meaning in the law and legal practice.[10] There is still no widely accepted definition of corporate governance, since it encompasses many distinctive features of countries such as the legal tradition, the level of economic development, culture and society.

Different jurisdictions have developed their own understandings of corporate governance models. It is not easy to classify countries' corporate governance systems, but probably the most useful classification is the insider model versus outsider models.[11] This classification draws a correlation between the degree of concentration of share ownership in listed companies and corporate governance systems.[12] The outsider system, in which ownership and control are separated, is only common in Anglo-American jurisdictions, whereas the insider model is more common in the rest of the world. For the purposes of this thesis, the main focus will be on the Anglo-American corporate governance models and the insider model will not be explored in any great detail.

2.2.1 Insider Corporate Governance Models

Insider corporate governance models, typical of continental Europe, are characterised by 'concentrated ownership or voting power and a multiplicity of inter-firm relationships and corporate holdings'.[13] In these jurisdictions, the control of quoted corporations is generally vested in large block-holders such as controlling families, banks, corporate groups and governments.[14] Corporate control by these dominant shareholders is intensified through the use of pyramids and multiple chains.[15]

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[10] Bob Tricker, *Corporate Governance: Principles, Policies, and Practices* (2nd Edition, Oxford University Press, 2011), 11-12.
[11] See note 1.
[12] John Armour, Simon Deakin and Suzanne Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41(3) *British Journal of Industrial Relations* 531, 533.
[13] Maria Maher and Thomas Andersson, 'Corporate Governance Effects on Firm Performance and Economic Growth' (OECD 1999), 23.
[14] Ruth Aguilera and Gregory Jackson 'The Cross-National Diversity of Corporate Governance: Dimensions and Determinants', (2003) 28 *Academy of Management Review* 447.
[15] Ronald Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy' (2006) 119(6) *Harvard Law Review* 1641, 1647.

Institutional shareholders such as pension funds, mutual funds and other collective investment schemes tend to play a limited role than is the case in the outsider model.[16]

The advantage of concentrated ownership or voting power is that shareholders with large stakes or voting power can actively monitor management performance and overcome problems associated with dispersed ownership. As a result, the 'separation of ownership and control'[17] is not an issue, because the problems regarding weak management accountability are reduced.[18] This is because, with more concentrated ownership (or voting power), shareholders receive more benefits from monitoring and have enough power to influence the company's strategies. In addition to increased monitoring, investors in the insider corporate governance model usually have long-term relationships with companies, which has a positive impact on a firm's performance and increases profitability in the long-run.[19]

2.2.2 Outsider Corporate Governance Models

The outsider models, typical of the United States and the United Kingdom, are characterised by relatively dispersed ownership and a highly active capital market. These systems aim to foster an effective and equitable distribution of information and emphasise the strong protection of shareholders.[20] Companies in the US and UK share a similar pattern of scattered share ownership, in contrast to companies in mainland Europe.[21] Since there is no shareholder with a large enough stake to exercise overall control, it is often argued that shareholders are generally weak and passive.[22] Both jurisdictions have well-developed securities markets and employ similar corporate governance mechanisms to promote managerial accountability. Given the dispersed ownership, regulation in these jurisdictions has been introduced to encourage transparency and to facilitate investors' access to information. The Anglo-American

[16] Maher and Andersson (n 13), 24.
[17] The separation of ownership and control refers to a situation in which a company is not controlled by its shareholders .
[18] John Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Clarendon Press 1994), xi.
[19] Maher and Andersson (n 13), 25.
[20] Maher and Andersson (n 13), 25.
[21] Aguilera and Jackson (n 14), 448-450.
[22] Fischel (n 4) 1276-8.

corporate governance models facilitate the development of financial markets and are therefore mostly designed to 'deal with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment… [and] control managers'.[23] The outsider systems also have some advantages such as enhanced liquidity of stocks and better risk diversification opportunities for investors.

The purpose of corporations is often regarded as maximising shareholder wealth;[24] therefore, shareholder wealth maximisation is placed at the heart of companies, and the corporations' interests are defined by the shareholders' interests.[25] The existence of dispersed ownership in public corporations and the predominance of shareholder wealth maximisation as a fundamental corporate objective distinguish the Anglo-American systems from other continental European corporate governance systems which are more stakeholder-orientated. For the purposes of this thesis, it is not necessary to examine in further detail the question of what the purpose of the corporation should be. Instead the primary focus will be on the allocation of power between shareholders and managers.

The one weakness of this classification is that it ignores the differences as to how corporate governance models approach to shareholder participation. The US and UK are often lumped together, and their differences are usually under-played and sometimes outright ignored because of the similar share ownership of public companies and their strong endorsement to shareholder primacy norm. However, these jurisdictions reveal far greater divergence as to the allocation of power between shareholders and directors than the literature usually assumes.[26]

Bainbridge incisively pointed out that the shareholder primacy norm connotes two different meanings: 1) the shareholder wealth maximisation norm which requires managers to make decisions according to the interests of shareholders, or 2) complete

[23] Andrei Shleifer and Robert Vishny, 'A Survey of Corporate Governance', (1997) 52 *The Journal* of *Finance* 737.
[24] Brian Cheffins, 'The Metamorphosis of 'Germany Inc.': The Case of Executive Pay', (2001) 49 (3) *The American Journal of Comparative Law* 497, 499-500.
[25] Parkinson (n 18), 77.
[26] Caroline Bradley, 'Transatlantic Misunderstandings: Corporate Law and Societies' (1999) 53 *University Of Miami Law Review* 269, 279.

shareholder control over the corporation's affairs.[27] However, director primacy theory argues that the ultimate corporate control should be vested in the board of directors.[28] Therefore, as opposed to the implied assumption of a stable and unified Anglo-American corporate governance model, director primacy theory accords with US company law, while shareholder primacy describes the UK law.[29] The following section will examine the emergence of these different theories in allocating power between shareholders and directors.

2.3 Core Feature of the Outsider Corporate Governance Model: The Separation of Ownership and Control

The separation of ownership and control is one of the core and most controversial attributes of Anglo-American corporate governance systems.[30] The unique share ownership structure of corporations was identified in what still may be one of the most influential works on corporations, namely *The Modern Corporation and Private Property* by Berle and Means.[31] The publication of this book changed the direction of the theoretical debate on company law. Shareholders were presented as passive investors and dissociated from active management. Since its publication, an important view in company law has been that managers in public corporations escape from effective shareholder control because corporations are held by a large number of shareholders.[32]

This ownership structure leads to the emergence of the image of weak and passive shareholders due to free-rider and collective action problems.[33] It is usually

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[27] Stephen Bainbridge 'Director v. Shareholder Primacy in the Convergence Debate' (2002) 16 *The Transnational Lawyer* 45, 45-6.
[28] Bainbridge (n 6) 547.
[29] See Bainbridge (n 28); UK corporate law is far more shareholder centric than US corporate law, see Christopher Bruner, *Corporate Governance in the Common-Law World: The Political Foundations of Shareholder Power* (CUP 2013); Edward Rock, 'Adopting to the New Shareholder-Centric Reality' (2013) 161 *University of Pennsylvania Law Review* 1907, 1978.
[30] Stephen Bainbridge, *The New Corporate Governance in Theory and Practice* (OUP 2008) 4.
[31] Berle and Means (n 2); for the share ownership of companies in the UK see Brian Cheffins 'Does Law Matter?: The Separation of Ownership and Control in the United Kingdom' (2001) 30 *JLS* 459, 465.
[32] John Lowry and Arad Reisberg, *Pettet's Company Law: Company Law & Corporate Finance* (Pearson 2012), 60.
[33] Fischel (n 4), 1276-8.

rational for shareholders to remain passive because 'when shares are widely traded, no one has the right incentive to gather information'[34] to engage in decision-making. Since shareholders usually own a small fraction of the total shares of a company, they will receive a small portion of the total benefit arising from activism. Therefore, collective action theory assumes that shareholders are not generally expected to submit shareholder proposals or oppose management proposals unless their expected benefit outweighs its costs. Furthermore, other shareholders could free ride on the efforts of engaging shareholders without bearing the cost of activism.

Another factor that contributes to shareholder passivity is the availability of an easy exit option. Despite the fact that corporate law provides some control rights to shareholders,[35] it is often assumed that 'there is no reason why shareholders who supply capital to the firm should have any interest or expertise in managing the firm's affairs' because of the high costs of being informed and the relatively small expected benefits.[36] It is usually easier and more rational for them to exit or to be passive rather than to become involved in decision-making. This is called 'rational shareholder apathy'.[37] Shareholder voting is therefore mostly regarded as unimportant.[38]

The separation of ownership and control 'removed many of the checks which formerly operated to curb the misuse of wealth and power'.[39] Berle and Means' thesis revealed a control gap in public companies which continues to constitute a major shortcoming for large companies. It also provided the foundation of the image of weak and passive shareholders. As will be seen below, such an understanding has resulted in recalibration of the role of shareholders as capital providers, who will rationally prefer exit to voice.

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[34] Easterbrook and Fischel (n 3) 25.
[35] Brian Cheffins, *Company Law: Theory, Structure, and Operation* (OUP 1998), 61-2.
[36] Frank Easterbrook and Daniel Fischel, 'Voting in Corporate Law' (1983) 26(2) *The Journal of Law & Economics* 395, 420.
[37] Easterbrook and Fischel (n 3) 65-68.
[38] Easterbrook and Fischel (n 36) 402.
[39] *Louis K. Liggett Co v Lee*, 288 U.S., 517, 548 (1933).

2.4 Theories Explaining the Internal Structure of Corporate Governance

Given the significance of the separation of ownership and control, corporate governance theories have been developed in order to address the problems arising from this separation. The existence of the separation has a normative dimension, which can suggest changes in company law or the maintenance of the status quo.[40] There are a number of theories which analyse the different aspects of corporations. These approaches could be classified into two broad groups depending on whether they perceive company law to be the result of private bargaining in the market or a centralised regulatory state imposition.[41] It is impossible to examine all theories, so this thesis will focus on key aspects of contractarian theory which dominates in the US.[42]

2.4.1 Contractarian Approach

2.4.1.1 Transaction Cost and Team Production Theories

Until Coase's influential 1937 article, *The Nature of Firm*,[43] it was assumed that the economic system was coordinated by the price mechanism.[44] Coase found that there are costs to using the price mechanism such as the costs of negotiating, concluding and enforcing a contract.[45] Once those costs were considered, the most efficient and economical way to organise production might be by forming a firm. Therefore, firms are an alternative to contracting in the market, with the aim of minimising transaction costs. This can be seen as the earliest sign of the contractarian understanding of the company. The firm is defined as a 'system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur' and the distinctive

[40] John Lowry and Arad Reisberg, *Pettet's Company Law: Company Law and Corporate Finance* (4th edition, Pearson 2012) 57.
[41] Marc Moore, *Corporate Governance in the Shadow of the State* (Hart 2013) 4.
[42] William Bratton, 'The Nexus of Contracts Corporation: A Critical Appraisal' (1989) 74 *Cornell Law Review* 407, 419; Moore (n 41) 62.
[43]Ronald Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386
[44] Oliver Williamson and Sidney Winter (eds) *The Nature of the Firm Origins, Evolution, and Development* (OUP 1991) 3.
[45] Coase (n 43) 391.

feature of a firm is the existence of an authoritative body directing the allocation of resources and production.[46]

Alchian and Demsetz accepted that higher transaction costs in the market make organising production within a firm advantageous[47] but it was necessary, they argued, to explain the conditions under which the cost of production within the firm could be lower than the cost of allocation of resources across the market.[48] They proposed that firms 'have no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people' because the relationship between them is a 'quid pro quo' contract.[49] In this context, shareholders are better described as 'investors' who contribute capital in exchange for the right to receive the residual profits.[50]

Rather than an authoritarian directive, team production and a centralised body within a set of contractual arrangements are identified as the defining features of a firm.[51] Since the firm is defined by the team production under a centralised body, the need for measuring marginal team production and the monitoring of potential shirking activities of the team members become major problems for the firm.[52]

A policing function, therefore, was needed within the firm if it were to be run efficiently. They suggested that a centralised and contractual agent who is the residual claimant (i.e. the shareholder) who has the greatest incentive not to shirk would monitor the team members.[53] They claimed that, in order to reduce shirking and to discipline team members, team members would transfer the right to alter individual membership and performance as well as the residual claimant's right to the central party common to all contracts; therefore, the monitoring agent would possess the bundle of rights.

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[46] Coase (n 43) 393, 403-4.
[47]Armen A. Alchian and Harold Demsetz, 'Production, Information Costs, and Economic Organization' (1972) *The American Economic Review* 777, 783.
[48]Alchian and Demsetz (n 47) 783-4.
[49] Alchian and Demsetz (n 47) 777, 783.
[50] Alchian and Demsetz (n 47) 789 footnote 14.
[51] Alchian and Demsetz (n 47) 778, 794.
[52] Alchian and Demsetz (n 47) 779.
[53] Alchian and Demsetz (n 47) 782.

This analysis is important for Anglo-American corporate governance systems because it identifies and addresses the problem of aligning the interests of different constituencies in a corporation in order to generate an efficient result. The implications of the theory are that firms run by unconstrained managers are not efficient due to the divergence of interests, and they should be under the control of shareholders.

2.4.1.2 Corporations as a Nexus of Contracts

Jensen and Meckling, following Alchian and Demsetz, developed the corporation as a nexus of contracts theory and subsequently agency cost theory by embodying managerial incentives.[54] Since then, the contractarian approach has dominated legal and economic discourses in the US as to the nature of public companies and has become the prevailing view in academia.[55] In its simplest form, this theory holds that the firm is a legal fiction which serves 'as a nexus for contracting relationships and which is also characterised by the existence of divisible residual claims on the assets and cash flows of the organisation which can generally be sold without permission of the other contracting individuals'.[56] Therefore, the company consists of implicit and explicit bargains between different actors of production such as investors, employees and creditors.

This theory emphasises the relationship between shareholders and managers, and defines it as an agency relationship; that is, 'a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent.'[57] This theory assumes that parties to the corporate contract are rational and seeking to maximise their own divergent interests and the managers are no exception to this premise. Therefore, the interests of managers and shareholders might diverge because both parties would likely wish to maximise their own return. The costs arising from managers acting opportunistically, the costs of monitoring them and the costs of

[54] Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305.
[55] William Bratton, 'The Nexus of Contracts Corporation: A Critical Appraisal' (1989) 74 *Cornell Law Review* 407, 419.
[56] Jensen and Meckling (n 54) 311.
[57] Jensen and Meckling (n 54) 308.

aligning the interests of managers and shareholders in order to prevent the managers from shirking are called 'agency costs'.[58] These are often specifically referred to as 'vertical agency costs'.[59] Agency costs are the inevitable consequence where decision-making is delegated to individuals who do not bear the financial outcomes of their decisions. These costs could be tolerable when the gains from specialised management are higher than the sum of residual loss to investors and monitoring expenses. The primary reason for the monitoring cost is the information asymmetry between the principal and the agent; the principals do not have the same level of knowledge about the company as their agents.[60] Monitoring activities and detection of mismanagement are generally costly for shareholders; therefore, investors tend to minimise the risk by diversifying their investments and have little incentive for ownership at the micro level.

In the context of the nexus of contracts theory, the firm is a 'complex set of explicit and implicit contracts'[61] which sets out the way in which the outputs of production are shared among the different constituencies. The responsibilities, duties and benefits of each party are defined by the contracts. All constituencies have contractual status.[62] Shareholders supply capital to the firm and managers contribute the specialised decision-making skills to the firm. Easterbrook and Fischel stated that

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[58] Jensen and Meckling (n 54) 308.

[59] In the literature, it is accepted that there are two additional types of agency costs. The first, known as horizontal agency cost, arises between majority and minority shareholders. The horizontal agency problem is mainly found in closely held companies and large public companies having a controlling shareholders in insider systems of corporate governance. The aim of the horizontal dimension is to prevent majority shareholders from exploiting their position at the expense of minority shareholders. The second agency cost is between shareholders and creditors. The last type is based on the fact that corporate decisions primarily aim to maximise shareholders' value, even to the detriment of creditors. See, Mark Roe, `The Institutions of Corporate Governance` in Claude Ménard and Mary M. Shirley` in Claude Ménard and Mary M. Shirley (eds), *Handbook of New Institutional Economics* (Springer 2008) 371.

[60] John Armour, Henry Hansmann, and Reiner Kraakman, 'Agency Problems and Legal Strategies' in Reiner Kraakman et al., (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edition, OUP, 2017) 29.

[61] Frank Easterbrook and Daniel Fischel, 'The Corporate Contract' (1989) 89 *Columbia Law Review* 1416, 1418.

[62] Jonathan Macey, 'Fiduciary Duties as Residual Claims: Obligations to Non-shareholder Constituencies from a Theory of the Firm Perspective' (1999) 84 *Cornell Law Journal* 1266, 1274; Julian Valesco, 'The Fundamental Rights of the Shareholder' (2006) 40 *UC Davis Law Review* 407, 445.

'it is all a matter of enforcing the contracts, and for any employee or investor other than a residual claimant, that means the explicit, negotiated contracts'.[63]

Shareholders are distinguished from other constituencies by virtue of 'the special nature of the claim held by equity investors - a claim to "what is left over" rather than to a definable return such as a wage or payment of interest'.[64] The theory assumes that shareholders enter into a contract with the management 'for a promise to maximise long-run profits of the firm, which in turn maximises the value of their stock'.[65] Accordingly, directors and managers will try to maximise shareholder wealth and secure and protect the investment of shareholders in the corporation. The responsibilities and duties of the management are therefore limited to protecting and enhancing the investment of shareholders. Conversely, non-shareholder constituencies have fixed claims by virtue of their contractual relationship.[66] This is the justification for shareholders enjoying structural exclusivity, which is to say: 'the entitlement to be regarded as the ultimate beneficiary of the accountability norms to which the board – and, indirectly management – are ordinarily subject in exercising their executive discretion'.[67]

In the context of law and economics discourse, the shareholder franchise is justified on the grounds of the shareholders' status as the residual claimant and as the principal in the agent-principal relationship with directors and management.[68] Since shareholders are the residual claimants, they are often assumed to have the greatest incentive to maximise shareholder value, 'the appropriate incentives… to make discretionary decisions'[69], and to control the management from shirking. The provision of controlling rights to shareholders is justified by reference to the specific

[63] Easterbrook and Fischel (n 3) 37.
[64] Easterbrook and Fischel (n 3) 25.
[65] Easterbrook and Fischel (n 3) 36.
[66] Easterbrook and Fischel (n 3) 11.
[67] Moore (n 41) 74.
[68] Paul Edelman et al, 'Shareholder Voting in an Age of Intermediary Capitalism' (2014) 87 *Southern California Law Review* 101, 115.
[69] Easterbrook and Fischel (n 38) 403.

characteristic of their contracts and the fact that shareholders are the most vulnerable to corporate decisions.

The contractarian approach adopts a different view about shareholder participation and empowerment. The proponents of contractarian theory are not generally worried about the lack of shareholder rights or activism because they often rely on the 'Wall Street Rule': if shareholders are unhappy with management, they will exit the firm rather than bearing the costs of objecting with a view to changing the way the company is managed.[70] In the contractarian approach, shareholders are also not willing to participate in the management of the company. First, shareholders contribute capital but not managerial skills, and managers provide entrepreneurial skills but not capital.[71] Second, unless shareholders own all of the shares in a company, no shareholder would have the right incentives or expertise to participate in corporate management intelligently.[72] Third, 'if investors gain from additional participation, one might expect legal rules or private contracts to reflect that fact'.[73]

Increased shareholder participation would be value-reducing for companies because it would destroy the efficiency benefits of centralised management. Similarly, many calls for legal reform are unnecessary because the reforms are usually based on 'the behavioural assumption of the interested and attentive shareholder', but the reality is likely to be the opposite.[74] Any legal means would be used by minority shareholders and since the additional regulatory costs imposed on companies would be shared among all shareholders, the aggregate impact of these reforms would be value-decreasing. For example, shareholder rights to submit proposals could be profoundly antidemocratic because only a minority of the shareholders would use the corporate budget to put forward the shareholder proposals which would mostly be defeated by a majority of the shareholders.[75] As such, legal reforms to increase shareholder

[70] See generally, Easterbrook and Fischel (n 38).
[71] Easterbrook and Fischel (n 36) 401.
[72] Easterbrook and Fischel (n 36) 402.
[73] Easterbrook and Fischel (n 36) 398.
[74] Easterbrook and Fischel (n 36) 422-3, 427.
[75] Easterbrook and Fischel (n 36) 423-5.

involvement are actually value-decreasing due to the costs arising from the extra regulations.

Thus, under contractarian theory, shareholders retain a privileged position. However, shareholder participation is value-reducing and unnecessary because of shareholder passivity, the cost of increased regulation and the efficiency of the market. Still, the contractarian theory has generated two different approaches with regard to the allocation of decision-making powers in companies: shareholder primacy and director primacy theories.

2.4.2 Shareholder Primacy and Director Primacy Theories

The proponents of shareholder primacy theory seek to bridge the gap between ownership and control by attributing the ultimate control to shareholders. Director primacy theory, however, conceives the separation of ownership and control as the core feature of public companies, essential for their viability. A prominent Delaware judge described these two different theories as 'duelling camps'. [76] This distinction reaches beyond academia to the marketplace and to public debate. On both sides of the debate, academics have developed arguments for more or less shareholder or director power, or to defend the status quo.

2.4.2.1 Shareholder Primacy Theory

The intellectual foundation of shareholder primacy theory is the contractarian approach which argues that shareholders own the residual claims to the assets of companies and that the agent-principal relationship defines public companies. Since it is assumed that agents, directors and managers, are tempted to follow their personal interests rather than shareholders' and companies' interests, shareholders as residual claimants have appropriate incentives to monitor the board and managers in order to protect their own interests. In the context of shareholder primacy theory, the primary concern of company law should be to minimise agency cost problems in corporate

[76] Leo Strine, 'Can We Do Better by Ordinary Investors; A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law' (2014) 114 *Columbia Law Review* 449, 474.

governance, i.e. the accountability of directors and managers,[77] and shareholder power is justified on the grounds of residual claims and agency costs.

This approach develops a decision-making model in which ultimate control should rest with shareholders to minimise agency cost problems because of their appropriate incentives to make efficient decisions.[78] This is similar to Alchian and Demsetz's model discussed above which combines the roles of ultimate monitor and residual claimant. This model is called the 'standard shareholder-oriented model'.[79]

Shareholder primacy theory regards shareholder empowerment as an important governance strategy to deal with agency cost problems.[80] In particular, the 2007-2008 financial crisis has led academics and lawmakers to focus on shareholder empowerment to minimise agency costs and enhance the sustainability of firms.[81] It assumes that where shareholders are given both strong and exclusive control rights, they will value and use these rights effectively to maximise shareholder value. Therefore, shareholder empowerment is primarily justified in the context of allocative efficiency and economic forces.[82]

2.4.2.2 Director Primacy Theory

The opposite of shareholder primacy is the director primacy theory, which again originates from the prevailing contractarian theory discussed above. Since the contractarian approach defines shareholders as residual claimants, one may legitimately ask why they do not manage the companies or why it is that the contractarian approach envisages a limited role for shareholders. Bainbridge provides the most comprehensive theoretical explanation about why shareholders are and should be disempowered, and the board authority should be empowered and

[77] Klaus Hopt 'Comparative Company Law' in Mathias Reimann and Reinhard Zimmermann (eds) *The Oxford Handbook of Comparative Law* (OUP, 2006) 1180-86.
[78] Hansmann and Kraakman (n 7) 441.
[79] Hansmann and Kraakman (n 7) 440.
[80] John Armour, Henry Hansmann, and Reiner Kraakman, 'Agency Problems and Legal Strategies' in Kraakman et al eds. (n 60) 42.
[81] See for example, Jonathan Mukwiri and Mathias Siems, 'The Financial Crisis: A Reason to Improve Shareholder Protection in the EU' (2014) 41 *Journal of Law and Society* 51.
[82] See, Hansmann and Kraakman (n 78) 449; Lucian Bebchuk, 'The Myth of the Shareholder Franchise' (2007) 93 *Virginia Law Review* 675.

preserved.[83] Unlike the traditional law and economics approach, director primacy theory does not consider the board as a source of agency costs; instead, it distinguishes the board from management and regards the board as being capable of effectively monitoring management. It argues that board authority should be protected for the efficient decision-making in large corporations.

This theory has two dimensions: first, the board of directors has and should have the ultimate authority and second, shareholders are the primary beneficiaries of the directors' fiduciary duties.[84] In this section, the focus will be on the first dimension of director primacy theory. It has both descriptive and normative aspects. With regard to the descriptive aspect, the board of directors in the US has not only the responsibility but also the right to manage companies without any intervention by outside parties including the shareholders.[85] In the US, shareholders' involvement in corporate decision-making is significantly restricted; Bainbridge therefore argues that shareholders' rights barely qualify as part of corporate governance, and that 'corporation law virtually carves the separation of ownership and control into stone',[86] and concludes that the US corporate governance model is better described by director primacy.[87]

The theory normatively claims that the board should have the ultimate authority and should be at the centre of corporate governance. It is argued that the corporation is a 'vehicle by which the board of directors hires various factors of production'; thus, the board is a 'sui generis body – a sort of Platonic guardian'.[88] It is assumed that the limited role of shareholders is a consequence of the hypothetical bargain between directors and shareholders. It is, therefore, the 'majoritarian

[83] Generally see Bainbridge (27) Bainbridge (28); Bainbridge (30).
[84] Bainbridge (n 28) 550; Bainbridge, (n 30) 10.
[85] Moore (n 41) 78.
[86] Bainbridge (n 87) 4.
[87] See generally, Stephen Bainbridge, (n 30) 53-4.
[88] Bainbridge (n 28) 550.

default'.[89] However, this raises a core question: once shareholders are accepted as residual claimants, why would they accept such a relatively weak position?

The intellectual foundation of a centralised decision-making body relates to Coase's influential theory of the firm.[90] A centralised body, which has the authority to direct the process of production and to make adaptive changes can reduce the transaction costs arising from uncertainty and complexity in the market, and the unforeseen situations and opportunistic behaviour of parties by virtue of incomplete contracts. Therefore, authority emerges as a vital survival feature of public companies. The centralised body in Coase's conceptualisation could be a hierarchical authoritative body or a collegial and consensus based decision-making body. One may ask why large companies tend to adopt the hierarchical decision-making body which is empowered to take binding decisions for the firm rather than a consensus based decision-making body, and what survival advantages the authority-based management provides. Arrow's influential book, *The Limits of Organisation* answers these questions as follows: where the members of an organisation have divergent interests and different levels of information, it is more efficient and cheaper to transmit all information to a centralised authority in order to make collective and informed decisions.[91] This authority in fact provides an efficient specialisation and division of labour. It is therefore rational for residual claimants to delegate authority to centralised management.[92] According to the director primacy theory, shareholder meetings are not regarded as a decision-making body because shareholders have neither identical interests nor identical information. In contrast to shareholders, directors can provide specialised management, have more information as to the company and can make informed and sound decisions.[93] The upshot is that an authority-based decision-making body empowered to make binding decisions provides large companies with survival advantages.

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[89] Bainbridge (n 30) 35-7 ('majoritarian default' means 'providing the rule to which the parties would agree if they could bargain').
[90] Coase (n 43).
[91] Kenneth Joseph Arrow, *The Limits of Organization* (Norton 1974) 63-79.
[92] Eugene Fama and Michael Jensen, 'Agency Problems and Residual Claims', (1983) 26 *Journal of Law and Economics* 32.
[93] William Bratton and Michael Wachter, 'The Case Against Shareholder Empowerment' (2010) 158 *University of Pennsylvania Law Review* 653, 688-709.

Director primacy theory, thus, does not accept that addressing the director accountability problem is the only challenge facing public companies. In contrast to shareholder primacy theory, it also regards the protection of the board's authority as a key condition of corporate governance. Therefore, it identifies accountability and authority as the two core values of company law. From this perspective, it argues that there is a trade-off between these two values:

> 'On the one hand, directors must be held accountable for violating their obligation to maximise shareholder wealth. On the other hand, the substantial virtues of fiat can be ensured only by preserving the board's decision-making authority from being trumped by either shareholders or courts. Resolving that tension turns out to be the chief problem of corporate governance.'[94]

Director primacy theory resolves this problem by favouring authority to accountability where there is a tension between these concepts. The core normative argument of the theory is that a legal framework should privilege authority over accountability and makes a normative claim that directors should have the ultimate authority in a company.[95] In justifying his position, Bainbridge refers to Arrow's comments that 'if every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem'.[96] Therefore, Bainbridge concludes that 'unfortunately, they are ultimately antithetical: one cannot have more of one without also having less of other' and that 'one must not lightly interfere with management or the board's decision-making authority in the name of accountability'.[97] It is almost impossible to deny the value of authority within large companies, but Bainbridge adopts a near-absolute approach, that is, any accountability mechanisms or interference with management would destroy the value of authority. He does not accept the possibility that accountability and authority can coexist.

This near-absolute approach does not allow for the possibility that shareholder activism has different types or could vary from institutional shareholder to institutional

[94] Bainbridge (n 30), 75.
[95] Bainbridge (n 30),10.
[96] Arrow (n 91), 78.
[97] Bainbridge (n 30), 113.

shareholder.[98] Since shareholder activism inevitably requires shareholders to make management decisions and to take action when management underperforms, shareholder activism is slightly different from the situation in which shareholders have 'power to make management decisions in the first place'.[99] Even the right to submit shareholder proposals is considered micro-management of the firm within the framework of this theory.[100] Therefore, giving shareholders power to review management's decisions means shifting some authority from the board and management to shareholders. Shareholder activism must be constrained to maintain the value of authority.

The theory does not deny the relevance of agency cost problems in large companies but finds that agency analysis imperfectly applies to corporate governance because these costs are the natural outcome of forming a centralised management structure. Company law could only address these problems by eliminating discretion, i.e. significantly diminishing the value of the board.[101] Therefore, authority should be the primary concern of company law rather than accountability, and preservation of managerial discretion should always be the default presumption.[102] Shareholders are not considered the ultimate monitors because 'in general, shareholders of public corporations have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation's agents'.[103]

In summation, shareholder primacy focuses on the accountability of directors and managers and seeks to vest the ultimate control with shareholders. Director primacy theory is, however, concerned with the authority of directors, i.e. the benefits of specialised and centralised management. Director primacy theory finds shareholder participation unnecessary because it reduces board authority and there are other

98 Bainbridge (n 30) 234.
99 Bainbridge (n 30) 234.
100 Stephen Bainbridge, 'Revitalizing SEC Rule 14a-8's Ordinary Business Exemption: Preventing Shareholder Micromanagement by Proposal' (2016) *UCLA School of Law, Law-Econ Research Paper No. 16-06*.
101 Bainbridge (n 28), 568.
102 Bainbridge (n 30), 235.
103 Bainbridge (n 30), 75.

accountability mechanisms which address agency problems without affecting that authority.

2.5 Do Corporate Control Mechanisms Provide Effective Monitoring of Management?

In this section, accountability mechanisms relied on by the contractarian theory and director primacy theory will be examined to understand whether, overall, these mechanisms provide effective monitoring and accountability. These mechanisms include: the market for corporate control, independent directors, executive remuneration and auditors.

2.5.1 The Discipline of the Market

There are three main markets that discipline managers: the product market, the market for managers, and the market for corporate control. It is argued that these markets impose discipline which is sufficient to ensure that managers' actions are in the interests of shareholders and to enhance managerial efficiency. [104] In this section, the disciplinary effect of the market will be examined in the context of the theory, the complex circumstances in which the theory operates, and the relevant legal framework.

2.5.1.1 The Product Market

The product market as a disciplinary tool relies on the common presumption that when a firm operates in a competitive market, there is no scope for managerial inefficiencies; therefore, competition enhances managerial efficiencies.[105] In highly competitive markets, the profits of underperforming firms generally decrease. This has at least two impacts on the relationship between the product market and managerial incentives. First, where overall profits decrease, the firm operating with high costs will underperform and fail to maximise profits. Therefore, the firm will experience difficulties in selling goods or services on the same terms as efficiently run companies and will be subject to a higher probability of liquidation. The failure to maximise

[104] Parkinson (n 18), 13.
[105] Klaus Schmidt, 'Managerial Incentives and Product Market Competition' (1997) 64 *Review of Economic Studies* 191.

profits will inevitably affect the managers because of the managers' firm-specific incentives and equity-based compensation scheme. This naturally induces managers to increase the firm's efficiency by reducing unnecessary costs. Second, in the worst-case scenario, a firm might be forced into liquidation if its managers are unable to reduce inefficiencies within the firm. Therefore, it is often assumed that managers are sufficiently incentivised through the competitive market to act in the interests of shareholders.[106]

It may not, however, decrease agency costs in the company because managers can still shirk in a well-performing firm. For example, they can simply divert profits to themselves which does not have any impact on the firm's efficiency and production costs, and ability to survive in product markets.[107] Large companies have sufficient resources to survive with substantial managerial inefficiencies. Consequently, managerial slack may not immediately translate into a credible threat of liquidation, so the product market may fail to discipline management adequately.

2.5.1.2 The Market for Managers

The second type of the discipline of the market is the market for managers.[108] Managers are subject to discipline coming from both outside and within the firm. Managers invest their human capital in the firm. The value of the human capital is likely to be measured in terms of the success or failure of the firm. The managers' success or failure in the past provides information about their talent. This has an impact on their future wages.[109] Depending on their previous success, managers are willing to get better positions, i.e. they are able to displace existing managers.[110] The market for managers and directors,[111] at least in theory, induces them to perform better to

[106] Henry Butler, 'The Contractual Theory of the Corporation' (1989) 11 *George Mason University Law Review* 114.
[107] Melvin Eisenberg, 'The Structure of Corporation Law', (1989) 89 *Columbia Law Review* 1461, 1489.
[108] The term 'the market for managers' entails both executives and directors.
[109] Eugune Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *The Journal of Political Economy* 288, 296.
[110] Alchian and Demsetz (n 64) 777.
[111] Eugene Fama and Michael Jensen, 'The Separation of Ownership and Control' (1983) 26(2) *Journal of Law and Economics* 301, 325.

obtain higher salaries. However, the relationship between performance in a previous appointment and consequences in the market may not always be clear.

The internal labour market of the firm may not be as strong as it is supposed. Many firms complain about the lack of obvious successors to current senior managers.[112] Although it holds true that competition among managers in a firm may provide a certain level of discipline, the internal dynamics of the board of directors preclude taking disciplinary action against insiders because executive directors and managers have a personal relationship and they will probably consider removing a manager in the event of evident incapacity or wrongdoing.[113]

There are two aspects of the market for managers which are overlooked in the literature. First, it is assumed that the success of managers is the only factor in the recruitment process. However, nowadays most recruitment is carried out though executive search firms on behalf of the company.[114] The success of managers may have a limited impact on the new appointments because the search market is dominated by only a limited number of search firms[115] and a small number of people in these firms administer the most important recruitment processes. Like all other people, they can bring a candidate's personality to the fore, rather than their skills and qualifications.[116] For example, executive search firms are criticised by diversity scholars because of the lack of equality and diversity in the recruitment process.[117] Second, the labour market for directors may not have a large enough pool of candidates to meet the increasing demand for independent directors and to maintain competition in the market.[118] Independent directors are often chosen from a limited pool of a 'self-perpetuating oligarchy' of individuals with similar social, economic and business

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[112] James Faulconbridge et al., 'The 'war for Talent': The Gatekeeper Role of Executive Search Firms in Elite Labour Markets' (2009) 40 *Geoforum* 800.
[113] Parkinson (n 18), 117.
[114] Ram Charan, 'Ending the CEO Succession Crisis' (2005) 83(2) *HBR* 72, 77; Monika Hamori, 'Who Gets Headhunted—and Who Gets Ahead? The Impact of Search Firms on Executive Careers' (2010) 24 *The Academy of Management Perspectives* 46.
[115] Charan (n 114), 77.
[116] Charan (n 114), 77.
[117] George Dreher et al., 'Mobility and Cash Compensation: The Moderating Effects of Gender, Race, and Executive Search Firms' (2011) 37 *Journal of Management* 651.
[118] James Linck et al., 'The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors' (2009) 22 *Review of Financial Studies* 3287.

backgrounds.[119] Clearly, the disciplinary effect of the outside labour market has serious shortcomings which undermine the theory.

In conclusion, the labour market for managers, including independent directors, is regarded as one of the primary disciplinary mechanisms for managers. However, this control mechanism may not be as effective as expected because of three core problems arising in practice.

2.5.1.3 The Market for Corporate Control

The third and most important market mechanism is the market for corporate control.[120] It exerts an external control mechanism over managers who fail to act in the shareholders' best interests.[121] This section will examine whether it is an effective means of reducing agency costs in corporate governance.

Some authors claim that the market for corporate control makes the outsider corporate governance model viable.[122] In theory, if management runs the company poorly, its shares will be valued lower than shares of similar but well-managed companies based on the assumption that share prices respond to failures of management.[123] A low share price will send a signal to outsiders of an opportunity to obtain large capital gains from the company by replacing incompetent or shirking managers with more efficient managers. The underperforming company is then run more efficiently by the new managers. In some cases, the threat of takeover also serves the same function in the improvement of managers' performance and the reduction of agency costs, even when an actual takeover does not occur.

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[119] Sarah Kiarie, 'Non-executive directors in UK listed companies: are they effective?' (2007) 17 *International Company and Commercial Law Review* 1, 3.
[120] Michael Jensen, 'Takeovers: Their Causes and Consequences' (1988) 2(1) *Journal of Economic Perspectives* 21.
[121] Daniel Fischel and Frank Easterbrook, 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981) 94(6) *Harvard Law Review* 1161, 1169.
[122] John Armour and David Skeel 'Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation' (2007) 95 *The Georgetown Law Journal* 1727, 1729.
[123] Daniel Fischel, 'Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers' (1978) 57(1) *Texas Law Review* 4.

The theory of the market for corporate control is well-established, but there are crucial shortcomings in the theory which undermine its functioning and relevance. First of all, the theory is based on the efficient market hypothesis (EMH), i.e. the notion that share prices reflect all available information and react immediately to new information[124] and assumes that financial markets are efficient.[125] However, EMH overlooks the supply and cost of information. It assumes that rational investors will use information until marginal conditions are met. It puts limited emphasis on the information with regard to the supply of investments.[126] With regards to the cost of information, no information can be generated for free.[127] In addition People often deviate from economic rationality in a number of areas. For example, Odeon describes a situation in which investors are reluctant to sell shares that lose value as a result of loss aversion and the hope that these shares will outperform their current winning shares.[128] Finally, the analysis of financial crises also challenges EMH, which underpins financial market regulation in the US and UK and questions the assumptions on which the theory is grounded. EMH has been blamed for the financial crisis because it overlooks the dangers of bubbles.[129] As a result, it seems reasonable to recognise that the market cannot be acting rationally all the time and that share prices do not reflect all available information.

Second, some empirical evidence shows that the link between poor performance of a target company and takeovers is weaker than expected.[130] there is some evidence suggesting that weak companies are less likely to become targets for potential bidders and that potential bidders are looking for excellent management.[131]

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[124] Eugene Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *The Journal of Finance* 383.
[125] Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioural Finance* (OUP 2000) 1.
[126] Ray Ball, 'The Development, Accomplishments and Limitations of the Theory of Stock Market Efficiency' (1994) 20 *Managerial Finance* 3.
[127] Ball (n 126), 29.
[128] Terrance Odean, 'Are Investors Reluctant to Realize Their Losses?' (1998) 53 *The Journal of Finance* 1775.
[129] See Jeremy Grantham's foreword in Andrew Smithers, *Wall Street Revalued: Imperfect Markets and Inept Central Bankers* (Wiley, 2009).
[130] Julian Frank and Colin Mayer, 'Hostile Takeovers in the UK and the Correction of Managerial Failure' (1996) 40 *Journal of Financial Economics* 163.
[131] John Coffee, 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance', (1984) 84 *Columbia Law Review* 1145,1211-2.

Such empirical evidence undermines the underlying assumption of the market for corporate control, which is that the underperforming companies are disciplined through the market. Another factor that dilutes the benefits of takeovers is the cost of takeovers. The costs involved in takeovers are so high that they can be considered an obstacle to the smooth operation of the market.[132] As noted by Frank and Harris: '[i]f many of these bids are simply vehicles for removing weak and inefficient management, then it seems very expensive to spend millions or even tens of millions to remove the chairman or part of the board of directors… [i]t is like buying an entire football team when only one player is wanted'.[133]

As a result, takeovers are accepted as one of the primary disciplinary mechanisms in monitoring management, but when the theory is considered in the context of criticisms of EMH and practical difficulties, its disciplinary function is far from complete. Takeovers might function as a disciplinary mechanism, but their capacity is limited and cannot be considered as a primary disciplinary mechanism.

2.5.2 Remuneration Contracts

Another mechanism which is considered a means of controlling agency costs is executive remuneration contracts.[134] In the 1990s, pay-for-performance contracts were seen as a way to align the interests of managers and shareholders and to give appropriate incentives to management. Thereafter, scholars focussed on how to design optimal remuneration structures.[135] Jensen and Murphy re-interpreted executive compensation and it was seen as a tool for reducing agency costs between shareholders and managers.[136] This approach, called 'optimal contracting approach',[137] offers two important justifications for 'pay-for-performance' arrangements: such contracts

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[132] Julian Frank and Robert Harris, 'Shareholder Wealth Effects of UK Takeovers: Implication for Merger Policy', in James Fairburn and John Kay (eds) *Mergers and Merger Policy* (OUP 1989) 148, 169-70.
[133] Frank and Harris (n 132) 169.
[134] Charles Yablon, 'Bonus Questions-Executive Compensation in the Era of Pay for Performance' (1999) 75 *Notre Dame Law Review* 271, 279.
[135] Lucian Bebchuk et al, 'Managerial Power and Rent Extraction in the Design of Executive Compensation' (2002) 69 *The University of Chicago Law Review* 751.
[136] Michael Jensen, and Kevin Murphy 'CEO Incentives -- It's Not How Much You Pay, But How' (1990) 68(3) *HBR* 138.
[137] Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press 2004).

incentivise managers to be more efficient, and they play a significant role in aligning the interests of managers with those of shareholders.[138]

Jensen and Murphy argued that excessive pay is not the problem; the problem is *how* managers are paid. [139] They suggested that the increased use of a pay-for-performance system (in turn, a higher dismissal possibility for unsuccessful managers) would lead to lower levels of income for less talented managers and over time, these less talented managers would be replaced with talented and motivated managers who would perform better and earn higher levels of compensation.[140] Performance-based executive pay incentivises managers to pursue the shareholders' agenda, and to perform better. In the end, it results in stronger corporate performance.

While excessive pay is not a problem in theory, it ignores the possibility of the reward for failure. Executive compensation has been subjected to much criticism in the wake of corporate governance failures. [141] The 2007-2008 financial crisis has drawn attention to the extremely high salaries of executives despite the very poor performance of companies.[142] Executive compensation turned into a risk management problem rather than a way of aligning the interests of shareholders and managers. The executives disregarded the long-term interests of the company and shareholders by hitting targets to receive extra high payments. This situation shows that the pay-for-performance theory has substantial defects and is not able to explain the problems of current executive pay regimes.

The optimal contracting theory suffers from a number of shortcomings which weaken the performance link at the heart of the theory and cause conflicts between shareholders and managers. A typical pay-for-performance contract in public companies contains three elements: a basic salary, a bonus related to the share price,

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[138] Randall Thomas and Kenneth Martin, 'The Determinant of Shareholder Voting on Stock Option Plans' (2000) 35 *Wake Forest Law Review* 31, 37.
[139] Jensen and Murphy (n 136), 138.
[140] Jensen and Murphy (n 136), 139.
[141] Randall Thomas, Alan Palmiter and James Cotter 'Dodd-Frank's Say On Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?' (2012) (97) *Cornell Law Review* 1213.
[142] Senate Committee Report No. 111–176, 133 (2010), available at https://www.congress.gov/congressional-report/111th-congress/senate-report/176/1accessed 25 April 2015.

and a stock option plan. It might also include other components such as pension rights and severance pay. The way that these components are connected, and the bargaining process might cause agency problems and break the link with performance. In contrast to the theory, after corporate failures, these elements were considered to be a contributing factor to the failures since they extended the gap between the interests of managers and shareholders.[143]

First, the success of pay-for-performance contracts depends on adequate control by the board of directors over management. It fails to take into account the realities of executive pay structures and managerial power.[144] Management may have significant influence over the board of directors and the board might lack the motivation to bargain for the best interests of shareholders for a variety of reasons.[145] Managers still have influence over the boards of directors.[146] As will be seen, independent directors may not be free of pressure from management. Second, share prices are often used in pay-for-performance contracts as a benchmark for the performance of the company. This situation incentivises managers to inflate corporate earnings to prevent a decline in share prices.[147] Since the Enron failure, it has been understood that executive managers were paid huge salaries and bonuses along with the CEO. It was revealed that targets were achieved by manipulating the accounts.[148] In addition to the manipulation problem, it is difficult to monitor the problem of postponing or accelerating the disclosure of information by managers. In practice, bad news about the company usually comes after, rather than before, the date on which managers use their stock options.[149] The increased use of stock options gives financial

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143 Guido Ferrarini and Niamh Moloney, 'Executive Remuneration in the EU: The Context for Reform' (2005) 21(1) *Oxford Review of Economic Policy* 304, 306.
144 Lucian Bebchuk and Jesse Fried, 'Executive Compensation as an Agency Problem' (2003) 17(3) *Journal of Economic Perspective* 71, 73-6; see also Marianne Bertrand and Sendhil Mullainathan 'Are CEOs Rewarded for Luck? The Ones Without Principles Are' (2001) 116 *Quarterly Journal of Economics* 901.
145 Lucian Bebchuk and Jesse Fried, 'Pay Without Performance' (2006) 20(1) *Academy of Management Perspectives* 5, 9.
146 This issue will be explored in detail in the Non-Executive Directors section. In order to avoid unnecessary repetition, the analysis will not be made here. Bebchuk and Fried (n 144),73.
147 Coffee (n 150) 203.
148 Kurt Eichenwald, 'Enron`s Many Strands: Executive Compensation', *The New York Times* (1 March 2002) < http://www.nytimes.com/2002/03/01/business/enron-s-many-strands-executive-compensation-enron-paid-huge-bonuses-01-experts.html> accessed 20 March 2017.
149 Yablon (n 134), 299.

incentives to CEOs to manipulate the substance and the timing of the financial and accounting statements of the company.[150]

Optimal contracting theory construes executive remuneration as a means to align the interests of managers and shareholders. This approach depends heavily on the board of directors as guardians of shareholders' interests. However, remuneration contracts may induce management to pursue their own interests, which in turn damages the efficiency and value of public companies, thereby reducing shareholder wealth and, indirectly, social wealth.

2.5.3 Audit

The primary role of audit is to provide a fair and true picture of companies to the market and the collective body of shareholders in order to create market trust and confidence.[151] The need for auditors derives from the agency theory.[152] The management of a company has incentives to present the company's situation in its best light.[153] These problems create a demand for an objective and independent audit process for corporations in order to verify that the financial statements present a fair picture of the company's actual position and ensure a periodic flow to investors of accurate information about the performance of the management. In theory, auditors exist to provide information, to monitor the activities of managers, to prevent managers from committing wrongdoing and manipulating the financial statements, and to provide confidence to the market.[154]

The success of auditors in corporate governance will depend on the discovery of wrongdoing in financial statements; it thereby reduces agency costs. This is possible only if the auditor is independent of the management.[155] If an audit firm is

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150 John Coffee, 'A Theory of Corporate Scandals: Why the USA and Europe Differ' (2005) 30 *Oxford Review of Economic Policy* 198, 201.
151 European Commission, 'Green Paper: Audit Policy: Lessons from the Crisis' COM(2010) 561 final
152 Ross Watts and Jerold Zimmerman 'Agency Problems, Auditing, and the Theory of the Firm: Some Evidence' (1983) 26(3) *Journal of Law and Economics* 613, 614-5.
153 David Kershaw, 'Waiting for Enron: The Unstable Equilibrium of Auditor Independence Regulation' (2006) 33(3) *Journal of Law and Society* 388, 390.
154 John Coffee *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press 2006) 2.
155 Watts & Zimmerman (n 152), 615.

independent, it is able to present an objective, true and fair report of a company's financial situation.[156] Otherwise, it might tend to overlook material errors or misrepresentations in the statements. Corporate governance failures such as Enron, WorldCom, Independent Insurance, Lernout & Hauspie, Vivendi and Parmalat[157] were all associated with audit failures[158] and in particular were deemed to be caused by a lack of auditor independence.[159] It has recently been asked how these financial institutions obtained clean audit reports just before they collapsed,[160] and the credibility of the auditors has been challenged on account of these clean reports.[161]

Auditor independence was not regulated substantively on either side of the Atlantic until the Enron failure.[162] According to Coffee, auditor independence regulation must ensure that the potential costs to auditors of compromised audits should outweigh the potential benefits from approving financial statements that are in favour of the client's management but are misleading to shareholders and investors.[163] Audit firms could receive luxury fees for the provision of non-auditing consulting services (NAS) such as tax consultancy, corporate finance, information technology and human resources. The provision of NASs to the same company creates a conflict of interest which has the potential to compromise the scepticism of the auditor because of the self-interest motive and financial dependence on the client;[164] the audit firm might be willing to please its client in order to provide lucrative NASs.

Following the Enron failure, the US preferred to regulate NASs and prohibited the provision of certain types of NAS.[165] Even though regulating this field is a positive

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156 *United States v. Arthur Young & Co. et al*. 465 U.S. 805, at 818 (1984).
157 John Coffee, 'What Caused Enron - A Capsule Social and Economic History of the 1990s' (2004) 89 *Cornell Law Review* 269.
158 Claudio Flores, 'New Trends in Auditor Liability' (2011) 12 *EBOR* 415, 416
159 Coffee (n 154) chp 5.
160 Prem Sikka, 'Financial Crisis and the Silence of the Auditors' (2009) 34 *Accounting, Organization and Society* 868, 869.
161 Flores (n 158) 417.
162 Werner Ebke, 'Corporate Governance and Auditor Independence' in Guido Ferrarini et al (eds) *Reforming Company and Takeover Law in Europe,* (OUP 2004) 516.
163 Coffee (n 157) 288.
164 Jose Joao Montes Ferreira-Gomes, 'Auditors as Gatekeepers: The European Reform of Auditors' Legal Regime and the American Influence' (2005) 11 *Columbia Law Journal* 665, 687.
165 Section 201 of the Public Company Accounting Reform Investor Protection Act (hereinafter referred to as 'Sarbanes Oxley Act of 2002' (SOX)).

step in enhancing independence, the inherent conflict of interest between the role of auditors and their financial expectation as a commercial entity still remains. The question remains as to '*whether one can trust a watchdog hired and paid by the party to be watched*'.[166]

Auditors' primary potential cost consists of the legal liability. Coffee established a link between the rapid decline in liability during the 1990s and acquiescent auditing.[167] In this context, the threat of litigation can be regarded as serving the regulatory function of deterring a compromised audit. Nevertheless, the internal dynamics of legal liability are not as straightforward as assumed by accounting scholarship in that it usually fails to consider legal rules.

First of all, the audited company's claim against the auditor is restricted. In US law, the company's claim against the auditor is also limited because the latter cannot be held responsible for damage if the wrongdoing is committed or known by the managers of the audited company.[168] An auditor can easily attribute the knowledge of wrongdoing to the audited company, even if he is negligent in conducting the audit. The auditors and client company are considered *in pari delicto.*[169] The client company, in return, can invoke the 'adverse interest defence', arguing that managers pursued solely their own interests and those of the company, and did not obtain any benefit from the wrongdoing[170] although in many cases the client company gains benefits from the misrepresentation in its financial statements.

Second, audit reports have a spill-over effect since they are widely used by different groups that do not have any contractual relationship with the client company. The company might seek to use audit reports to provide confidence to creditors.[171] The main question with regard to liability to non-contractual parties is whether auditors will be held liable if a third party relies on the reports. In the US, the answer to auditors' third party liability, at least broadly, was provided by the leading case of

[166] Coffee (n 154) 4.
[167] Coffee (n 154) 152.
[168] *Hirsch v. Arthur Andersen,* 72 F. 3d 1085 (3d Cir 1995).
[169] Paolo Giudici, 'Auditors' Multi-Layered Liability Regime' (2012) 13 *EBOR* 501, 524.
[170] *Sharp v KPMG* 278 BR (Bankr EDNY 2002).
[171] Giudici (n 169) 531.

Ultramares Corp v Touche.[172] The court did not impose any liability on the auditor for negligence because 'if liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class'.[173] The upshot of auditors' liability to third parties is that even though audit reports are used by non-contractual parties, auditors do not owe any responsibility unless certain conditions are met. Therefore, it has a limited deterrent effect on acquiescent auditing.

As a result, it is virtually impossible for an auditor to be completely independent of managers despite any regulatory improvements. Audit as a control mechanism does not carry out the role expected of it.

2.5.4 Independent Directors

As discussed above, a central decision-making body, i.e. the board of directors, is at the heart of every large company. The members of the board are formally elected by shareholders and bear collective responsibility for the management of the company's business. The role of the board has been evolving over time. According to Berle and Means, the board did not have much capacity to run the company and was accountable to and under the control of senior managers.[174] Over time, the institution of the corporate board has gradually been regarded as an important means to address agency cost problems in public companies.[175] There have been law and corporate governance rule changes aimed at empowering the board and reducing the impact of managers on the board. In the 1950s, boards were almost 'an extension of management'.[176] They used to carry out a primarily advisory rather monitoring role. Now, a majority of

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172 *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931) .

173 *Ultrames* (n 172) 179; For the history of auditor liability in the US see Jay Feinman, 'Liability of Accountant for Negligent Auditing: Doctrine, Policy, and Ideology', (2003) 31 *Florida State University Law Review* 17, 22-30.

174 Berle and Means (n 2) 116.

175 Moore (n 41) 82.

176 Jeffrey Gordon, 'The Rise of Independent Directors in the US, 1950-2005' (2007) 59 *Stanford Law Review* 1465, 1514.

directors of a typical listed company are independent directors.[177] Outside directors primarily carry out the monitoring function of the board by acting as an independent eye.[178] In other words, it is a mechanism to overcome the problems of separation by holding executives accountable for their performance.[179] The board is no longer only a passive advisor to management but also serves to monitor and control management. Such a transformation in the structure of the board of directors in fact constitutes the basis for director primacy theory because it is argued that with the help of a number of changes in the law and best practice, the board are strengthened to act as monitors on management's decisions and actions.[180] The board becomes independent of management and acts as the corporation's Platonic master.[181]

The requirements for independent directors are set out in the listing rules of the NYSE and NASDAQ.[182] All regulations place emphasis on not having a material relationship with the publicly traded company that would jeopardise NEDs' independence. While the primary aim of the inclusion of independent directors is to enhance the monitoring capacity of the board, the board is still expected to decide on strategic planning and to take important policy decisions.[183] The modern board of directors is, therefore, expected to serve two almost incompatible functions.[184] First, the board is the company's supreme executive body; thus, it is still responsible for developing and implementing business plans. The role of NEDs from a broader perspective is similar to executives because NEDs are expected to make significant contributions to the decisions of the board and to be involved in audit, nomination and remuneration committees.[185] Second, its duty is to monitor and discipline the

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[177] Paul Davies, 'Corporate Boards in the UK' in Paul Davies et al (eds) *Corporate Boards in Law and Practice* (OUP 2013) 717; Gordon (n 176); 303A.01 of NYSE Listing Rules; 5605(b)(2) NASDAQ Listing Rules; see also, Code Provision B.1.2. of the UK CGC.
[178] Jill Solomon, *Corporate Governance and Accountability* (3rd edition, Wiley 2010) 82.
[179] Ronald Gilson and Reinier Kraakman, 'Reinventing the Outside Director: An Agenda for Institutional Investors' (1991) 43(4) *Stanford Law Review* 863, 873.
[180] Bainbridge (n 30) 157.
[181] Bainbridge (n 30) 188.
[182] 303A.02 of NYSE Listing Rules; 5605 of NASDAQ Listing Rules; see also Principle B.1 of the Code.
[183] Lyman Johnson and Robert Ricca, 'Reality Check on Officer Liability' (2011) 67 *Business Lawyer* 75, 77-80.
[184] David Kershaw *Company Law in Context: Text and Materials* (2nd edition, OUP, 2012), 239.
[185] 303A.04., 303A.05., 303A.06., of the NYSE Listing Rules; 5605(b), 5605(d), 5605(e) of the NASDAQ Rules; see also, Code Provisions B.2.1., C.3.1., D.2.1. of the UK CGC.

managers.[186] The board of directors is assumed to be able to carry out a unique combination of managerial and monitoring roles.[187]

The increased independence requirements for NEDs help them to be more effective and to carry out their role, but the effectiveness and monitoring capacity of the independent boards has been challenged in the literature and after the financial crisis.[188]

First, the core difficulty is their independence from management. Despite the nominal independence of NEDs, it is often argued that they are too close to management.[189] The primary reason is that management is still dominant in the nomination of non-executive directors in the absence of shareholder contests.[190] NEDs who want to keep their position cannot be completely independent of management. Technically, shareholders are entitled to nominate and to appoint these internal monitors directly; however, in practice, it is usually predetermined by the current board.[191] This situation also shows that without active shareholder engagement, the formal legal right to appoint directors does not suffice to remove the influence of executives over NEDs.[192] Other research has shown that even though the CEO is not involved in the nominating committee, her or his influence cannot be ignored.[193] Therefore, management could have significant influence on the board of directors owing to the re-election concerns of independent directors. Management could be also willing to nominate independent directors, who will not challenge them. In this respect, the board could fail to scrutinise the merits of corporate strategies objectively and to monitor management adequately.

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[186] Cadbury Report paras 4.4, 4.5 and 4.6
[187] Bainbridge (n 30) 161.
[188] See Roman Tomasic and Folarin Akinbami, 'Towards a New Corporate Governance After Global Financial Crisis' (2011) 22(8) *International Company and Commercial Law Review* 237.
[189] Geof Stapledon, *Institutional Shareholders and Corporate Governance* (Clarendon Press 1996) 143.
[190] Victor Brudney, 'The Independent Director—Heavenly City or Potemkin Village?' (1982) 95 *Harvard Law Review* 597, 610.
[191] Bainbridge (n 87) 54.
[192] Mahmoud Ezzemal and Robert Watson 'Wearing Two Hats: The Conflicting Control and Management Roles of Non-Executives Directors' in Kevin Keasay, Steve Thompson, and Mike Wright (eds) *Corporate Governance: Economic and Financial Issues* (OUP 1997), 62.
[193] Brian Main, et al, 'The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives', (1995) 11 *Industrial and Corporate Change* 293, 302-3.

Second, the appointment of other executives or former retired executives to the board to act as NEDs constitutes another hurdle to NED independence as they are mostly considered to be 'less independent'.[194] Since executives want candidates who do not rock the boat, they serve such directorship when they are appointed as NEDs to other boards.[195] Many might even have a pre-existing relationship with the company and its executives.[196] They are less likely to carry out vigorous monitoring function because they usually share the same or similar values and approaches as executives. Therefore, NEDs might be biased in favour of insider managers or directors. Another factor limiting the monitoring functions of independent directors are board culture and behavioural biases that prevent independent directors from expressing their views freely. Board meetings are often described as having an emphasis on politeness and courtesy, which may accompany a failure in the monitoring function.[197] Sharpe states that 'the likelihood that an independent director will be willing to criticise a CEO is limited because her decision making is influenced by board room norms'.[198] Similarly, the financial crisis raises further questions whether the board is critical enough in scrutinising the management actions and decisions.[199] Furthermore, some managerial errors could be related to this dynamics of the board. The cognitive and behavioural limitations of small group decision making is subject to 'group polarisation', that is 'the tendency of a small deliberative group with an initial tendency to move in a given direction to move to even more extreme positions in that direction following group deliberations'.[200] Overall, this shows independent directors fail to challenge management and criticise corporate strategies in the boardroom. Such situation is

[194] Charlie Weir and David Laing, 'Governance Structure, Director Independence and Corporate Performance in the UK' (2001) 13(2) *European Business Review* 86, 87.
[195] Goerge Dent, 'Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance' (2007) 44 *Houston Law Review* 1213, 1241.
[196] Stapledon (n 189) 144.
[197] Micheal Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems' (1993) 48(3) *the Journal of Finance* 831, 863.
[198] Nicola Sharpe, 'Process over Structure: An Organisational Behaviour Approach to Improving Corporate Boards' (2012) 85 *South California Law Review* 261, 287-8.
[199] Iris Chiu, *The Foundations and Anatomy of Shareholder Activism* (Hart 2010) 26.
[200] Bernard Sharfman and Steven Toll 'Dysfunctional Deference and Board Composition: Lessons from Enron' (2008) 103 *Northwestern University Law Review* 153, 155.

against the raison d'être of independent directors and significantly reduces the capacity of the board to carry out the role assumed by director primacy theory.

Third and most importantly, the transition from an advisory board to a monitoring board creates information asymmetry between outsider directors, and insider directors and top managers, which severely restricts the ability of the board to monitor management. As NEDs often hold multiple positions on different boards, they lack the time, sufficient information, adequate resource and the right industry-specific knowledge to be involved in decision-making, or to monitor and challenge the strategic planning and important decisions of the company.[201] In the financial crisis, it was understood that NEDs in the financial institutions, which had difficulties, may not have sufficient knowledge and experience about the banking sector. [202] The outside directors are heavily dependent on the information that insider directors and top managers may choose to provide or to conceal or to present in a way that supports the position of management. They are less likely to obtain unfiltered and complete information on the company and to have independent access to information, which is a prerequisite for the board's oversight responsibility. The ability of the board to carry out the monitoring role and to verify the accuracy of the information is severely diminished because of the exclusive reliance on the management for information. Moreover, when the management provides the information, NEDs might not have appropriate resources or relevant industry specific knowledge[203] to critically analyse the information in a timely manner, given time restrictions.[204] More importantly, in some cases, management may prefer to withhold information from NEDs, in particular to the members of audit committees. This was particularly the case in the Enron and Equitable failures.[205] In the Enron failure, it was discovered that 'the board of directors

[201] See, Kobi Kastiel and Yaron Nili, 'Captured Boards: The Rise of the Super Director and the Case for a Board Suite' (2017) *Wisconsin Law Review* (Forthcoming).
[202] Chiu (n 199) 64.
[203] Lisa Fairfax, 'The Uneasy Case for the Inside Director' (2011) 96 *Iowa Law Review* 127.
[204] Nicola Faith, 'The Cosmetic Independence of Corporate Boards' (2011) 34 *Seattle University Law Review* 1435, 1454.
[205] Chiu (n 199) 23; William Powers, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corporation,* (1 February 2002) Part VII.A.

was denied important information that might have led it to take actions'.[206] Therefore, in terms of information, management might capture the board and the board could monitor management with filtered information.[207] Information asymmetry between directors and managers also contributes to the board alienation, which is the lack of awareness about management practices and operational realities. The board alienation problem has been the case in the Barings, Enron, Citibank, and Lehman Brothers failures, among other factors.[208] This shows that the board capacity to act as the Platonic master of the company is limited because of the board's overreliance on management and lack of expertise and skills.

As a result, the modern board is still expected to carry out the dual role: managerial and monitoring roles. Independent directors play a significant role in the modern board of directors. Director primacy theory posits that the board of directors could act as a sort of Platonic guardian of companies and shareholders. In fact, the board is more independent from management than ever before. The practice seems to be very close to the director primacy model. The analysis above, however, has demonstrated that the management could still have a strong influence over the board, that information asymmetry between the board and management, and the board dynamics prevents the board from carrying out the unique dual role. The board of directors fails to obtain sufficient information to evaluate the complexities of corporate transactions undertaken by management and to sufficiently criticise and challenge management in the boardrooms. This situation often undermines the validity of director primacy and plays a role in corporate governance failures.

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[206] William Powers, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corporation*, (1 February 2002) Part VII.A.

[207] Kastiel and Nili (n 201) 5.

[208] John Gapper and Nicholas Denton *All That Glitters: The Fall of Barings* (Penguin, 1997); Roman Tomasic and Folarin Akinbami, 'Towards a New Corporate Governance After Global Financial Crisis' (2011) 22(8) *International Company and Commercial Law Review* 237; Bernard Sharfman and Steven Toll, 'Dysfunctional Deference and Board Composition: Lessons From Enron' (2008) 103 *Northwestern University Law Review Colloquy* 153; *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A. 2d 106 (Del. Ch. 2009); Grant Kirkpatrick, 'The Corporate Governance Lessons from the Financial Crisis' (2009) 2009(1) *Financial Market Trends* 21-2.

2.6 Conclusion

In outsider corporate governance models, public companies are held by a large number of shareholders. This has led to the creation of the image of weak and passive shareholders in the company law literature. Under contractarian theory, shareholders are not expected to participate in the management of companies because their role is simply to supply capital, bear residual risk and invest in different companies, whereas directors and managers provide the specialised management and are good at decision-making. Contractarian scholars are generally not worried about the powerlessness of shareholders because of market efficiency and the benefits associated with centralised decision-making. Shareholders are not expected to participate in the decision-making of public companies. Director primacy theory makes a strong normative case in favour of the protection of the board authority and the disempowerment of shareholders. It finds shareholder activism inconsistent with efficient decision-making in public companies because of the inherent trade-off between authority and accountability. Addressing accountability concerns should not be the only concern of company law according to director primacy theory because agency problems are the natural outcomes of centralised management. A hierarchical centralised management must equally be the concern of company law because it addresses the problem of operating a large company. In contrast, shareholder primacy theory sees addressing accountability concerns as the principal function of company law, and attributes the ultimate control to shareholders to address accountability concerns. These two theories adopt two extreme approaches and have different focuses. While director primacy theory focusses on the economic efficiency of the corporate decision-making structure, shareholder primacy is built on the claim that directors and managers could pursue their own interests and maximise their own utility.

Director primacy theory may seem to be a complete theory because it does not deny the agency cost problem. However, in the context of the analysis pursued above, it is evident that the current mechanisms designed to reduce agency costs are far from perfect. They fail to provide effective control over management. More importantly, the theory falls short in that it assumes that the evolving board of directors could carry out a unique combination of managerial and monitoring roles in public companies.

This chapter, however, has demonstrated that the board's capacity to carry out such a role is more limited than the director primacy theory assumes. Information asymmetry between the board and management, and the board's overreliance on management cause the board alienation problem, which significantly undermines the validity of director primacy theory. Therefore, shareholder activism as an accountability mechanism is needed and could possibly have a positive impact on current corporate control mechanisms.

Chapter 3. Theoretical Aspects of Shareholder Activism

3.1 Introduction

This chapter aims to address the normative question of whether the evolving role of shareholders is desirable given the potential problems that shareholder activism might cause in corporate governance. In the previous chapter, the limited role of shareholders in corporate governance in the director primacy theory was discussed and a gap was demonstrated in the web of accountability mechanisms relied on by this theory.

Shareholder activism could potentially address agency and accountability problems in public companies. Chapter 2 demonstrated that the proponents of shareholder primacy rely on shareholder empowerment. They basically seek to give shareholders as much power as possible because it would make companies more efficient[1] and would maximise the firm value.[2] Therefore, scholars have sought to measure the success of activism by investigating its impact on the targeted firms' performance.[3] The link between shareholder activism and overall financial performance of the company is widely challenged in the literature, and as will be seen, the empirical evidence is inconclusive.[4] Hence, it is not sufficient to justify the role of

[1] See, Lucian Bebchuk, 'The Myth of the Shareholder Franchise' (2007) 93 *Virginia Law Review* 675; Henry Hansmann and Reiner Kraakman, 'The End of History for Corporate Law' (2001) 89 *The Georgetown Law Journal* 439; Bernard Black, 'Shareholder Activism and Corporate Governance in the United States' (1998) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=45100 accessed 10 May 2017;.

[2] See, Lucian Bebchuk, Alon Brav, and Wei Jiang, 'The Long-Term Effects of Hedge Fund Activism' (2015) 115 *Columbia Law Review* 1085; Alon Brav et al., 'Hedge Fund Activism, Corporate Governance, and Firm Performance' (2008) 63(4) *The Journal of Finance* 1729; April Klein and Emanuel Zur, 'Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors' (2009) 64(1) *The Journal of Finance* 187.

[3] Roberta Romano, 'Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance' (2001) 18 *Yale Journal on Regulation* 174, 176-7; Black (n 1); see for a literature review of empirical studies on shareholder activism, Stuart Gillan and Laura Starks, 'The Evolution of Shareholder Activism in the United States' (2007) 19(1) *Journal of Applied Corporate Finance* 55, 60-61 (Gillan and Starks examine 39 empirical studies on shareholder activism, and show that study results are mixed).

[4] See for example, John Coffee, and Darius Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2016) 1 *Annals of Corporate Governance* 1; see for another challenges in the past, Lynn Stout, 'The Mythical Benefits of Shareholder Control' (2007) 93 *Virginia Law Review* 789, 798–99 (finds weak evidence for greater shareholder franchise); Zohar Goshen and Richard Squire, 'Principal Costs: A New Theory for Corporate Law and Governance' (2017) 117

shareholder activism as an accountability mechanism. Moreover, as will be discussed, there are different types of shareholder activism which are used to increase the financial performance of companies or to bolster the social and political legitimacy of companies. They might not have an impact on share prices. In addition, policymakers and market institutions have begun to place emphasis on public interest concerns in the context of the role of shareholders. In this regard, the role of shareholder activism will be explored in the context of Hirschman's framework, namely *Exit, Voice, and Loyalty* because in this framework, voice, i.e. shareholder activism, is described as 'political action par excellence'.[5] In this framework, voice aims to change or to influence the actions or decisions of the board and management.

In the wake of the financial 2007-2008 crisis, lawmakers placed emphasis on shareholder activism to address public interest concerns such as short-termism in the market and facilitating long-term investment in the market, thereby ensuring the stability of the economy in general. The concept of stewardship was introduced in the UK as a response to the financial crisis.[6] This concept has also influenced policy on the other side of Atlantic. Major US institutional investors have issued a set of Stewardship Principles.[7] These principles are a result of bottom-up forces rather than a regulatory force. It indicates that major institutional investors show an interest in the long-term investment and major policies of companies and are willing to develop engagement with the board. Such development is important for US corporate governance because it introduces collaborative or constructive shareholder activism.

However, the role of shareholder activism in corporate governance is not universally endorsed by scholars.[8] There are serious concerns that shareholders could

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Columbia Law Review 765, section IV.A (Goshen and Squire also provide a literature review on the inconsistent relationship between the financial performance of the targeted companies and shareholder activism); see, Gillan and Stark (n 3) 60-61; Romano (n 3) 176-7.

[5] Albert Hirschmann, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States* (Harvard University Press 1970) 15-6.

[6] FRC, Stewardship Code (2012) < https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf>.

[7] The Investor Stewardship Group, < https://www.isgframework.org/> accessed 10 April 2017.

[8] See Stephen Bainbridge, 'The Case for Limited Shareholder Voting Rights' (2006) 53 *UCLA Law Review* 601; Stephen Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119(6) *Harvard Law Review* 1735; Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85(2) *Virginia Law Review* 247; Lorraine Talbot, 'Why Shareholders Shouldn't Vote: A

use their power to exploit the company for short-term gains at the expense of the long-term interests of the company, other shareholders, and stakeholders. In particular, activist funds are argued to be inherently detrimental to companies and the economy in general. Lawmakers should therefore consider these potential problems and, if they exist, should create optimal frameworks by constraining the potential deleterious side of shareholder activism.

3.2 Shareholder Activism in Corporate Governance

The governance role of shareholders has been evolving over time. The rise of institutional shareholders has led many academics to think that the ability of institutional shareholders to monitor management and to enhance managerial accountability would increase the protection of their investment through the private agency-based corporate governance framework.[9] Such defensive monitoring is usually perceived as being able to improve the efficiency of corporate governance which in turn enhances shareholder value and firm value.[10] However, as will be seen, there are different types of shareholder activism. So it is entirely possible that shareholder activism may be driven by financial, social or political motives. A broader framework is therefore needed to understand comprehensively the nature of shareholder activism. In this regard, Hirschman's framework which examines the relationship between exit, voice and loyalty in large organisations ranging from governments to companies could

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Marxist-progressive Critique of Shareholder Empowerment' (2013) 76(5) *MLR* 791; William Bratton and Michael Wachter, 'The Case against Shareholder Empowerment' (2010) 158 *University of Pennsylvania Law Review* 653; Iman Anabtawi, 'Some Scepticism about Increasing Shareholder Power' (2006) 53 *UCLA Law Review* 561; Alan Dignam, 'The Future of Shareholder Democracy in the Shadow of the Financial Crisis' (2013) 639 *Seattle Law Review* 640.

[9] The evolving nature of the shareholder landscape will be examined in the following chapter. Bernard Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice' (1992) 39 *UCLA Law Review* 811; John Coffee, 'Liquidity versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 *Columbia Law Review* 1277; Bernard Black and John Coffee, 'Hail Britannia: Institutional Investor Behaviour under Limited Regulation' (1994) 92 *Michigan Law Review* 1997; Brian Cheffins, *Corporate Ownership and Control: British Business Transformed* (OUP 2008) (it notes the hands-off approach of British institutional investors, in particular until 1990).

[10] Lucian Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 *Harvard Law Review* 835, 843; Lucian Bebchuk, 'The Myth of the Shareholder Franchise' (2007) 93 *Virginia Law Review* 675, 678.

provide a broader framework in which different types of shareholder activism could fit.[11]

The increasing scepticism about the monitoring capacity of the board and other mechanisms led policy-makers to take advantage of the increased shareholdings of institutional shareholders at the turn of the century.[12] In the post-crisis era, it is thought that shareholders should engage with management in order to address short-termism in the market and pressure by activist funds and day traders, and to facilitate the long-term value creation for the ultimate beneficiaries, the economy and society in general. This long-term value creation would enjoy the ‘implicit social legitimacy’ that constitutes the intellectual foundation of the UK Stewardship Code.[13] The role of shareholders is not only to achieve private objectives but also a matter of public interest. The development of shareholders as stewards has also influenced US corporate governance. Major institutional shareholders are developing new investor paradigms against short-termism and pressures by activist funds.[14] Institutional shareholders have promulgated the Stewardship Principles in the US.[15] This inevitably requires institutional shareholders to participate in the decision-making of companies. The evolving role of shareholders is of importance to US corporate governance because, as discussed in Chapter 2, the director primacy theory and standard contractarian theory recognise the limited role of shareholder participation in decision-making. These market developments are at odds with the dominant theory of US corporate governance. In summary, the governance role of shareholders now has two dimensions: an accountability mechanism for their private interests and an accountability mechanism that addresses public concerns facilitating long-term value creating and ensuring the sustainability of the broader economy.

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[11] Hirschman (n 5).
[12] See, Paul Davies, ‘Shareholders in the United Kingdom’ in Jennifer Hill and Randall Thomas (eds) *Research Handbook on Shareholder Power* (Edward Elgar 2015) 355, 371.
[13] FRC, Stewardship Code (2012) < https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf>.; see also John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision-Making* (July 2012).
[14] Martin Lipton, ‘The New Paradim’ (August 2016) *World Economic Forum* < http://www.wlrk.com/docs/thenewparadigm.pdf> accessed 27 March 2017
[15] The Investor Stewardship Group, < https://www.isgframework.org/> accessed 10 April 2017.

3.2.1 Shareholder Activism as an Accountability Mechanism

Dissatisfied shareholders in public companies have basically two options: exit the company or speak out against the board and management. In its traditional definition, shareholder activism is a process which aims to 'bring about change within the company without a change in control'.[16] It is broadly 'a continuum of responses to corporate performance and activities'.[17] The law and economics approach emphasised the exit option and overlooked the possibility of shareholder activism. This section seeks to answer the question whether shareholder activism could function as an accountability mechanism.

In the beginning of the twentieth century, shareholder activism was primarily used by powerful individual investors or firms, who were represented on the board and had direct influence over the management of the company.[18] With the formation of the Council of Institutional Investors (CII) in 1985, there has been an increase in shareholder involvement in corporate governance matters,[19] but it has had limited impact and success.[20] Such governance proposals such as the majority voting and the removal of anti-takeover defences failed to garner considerable support from shareholders or were ignored by the board and management.[21] However, as will be seen in Chapter 5, the support and effectiveness of such proposals increased substantially at the turn of the century.[22] In addition, since the 1960s, some institutional investors have been submitting corporate social responsibility proposals and trying to influence the board and management on corporate social responsibility issues.[23] These proposals cover issues such as local employment and economy

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16 Gillan and Starks, (n 3) 55.
17 Gillan and Starks (n 16) 56.
18 Gillan and Starks (n 16) 55.
19 Gillan and Starks (n 16) 56.
20 Paul Rose, 'Shareholder Proposals in the Market for Corporate Influence' (2014) 66 *Florida Law Review* 2180, 2190.
21 Rose (n 20) 2190.
22 See, Randall Thomas and James Cotter, 'Shareholder Proposals in the New Millenium: Shareholder Support, Board Response, and Market Reaction' (2007) 13 *Journal of Corporate Finance* 368, 388–89.
23 See, Katherine Clac, 'The Influence of Shareholders on Corporate Social Responsibility' (2014) 9(3) *Economics, Management, and Financial Markets* 34; Stuart Gillan and Laura Starks, 'A Survey of Shareholder Activism: Motivation and Empirical Evidence' (1998) 4 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=663523> accessed 10 June 2017.

considerations, the board's diversity, the environment, international labour and human rights, and anti-discrimination.[24] Social activists aim to make the behaviour of companies consistent with social norms. Shareholder activism on these matters may not have an impact on the share price. However, there are also activist funds, which also took a more central role in corporate governance in the mid-2000s,[25] whose primary aim is to generate 'abnormal' returns following the activism.[26] These investors are motivated by economic interests.

The desirability of shareholder activism is sought to be justified depending on its financial impact on the targeted company.[27] However, measuring the success of shareholder activism is problematic. First, identifying the activism might be difficult because shareholder activism can take place behind closed doors.[28] Such activism cannot be captured by empirical studies. Second, empirical studies fail to establish a causal link between shareholder activism and the increase in the efficiency and value of the target companies.[29] There are also empirical studies that note abnormal share price increases after shareholder activism.[30] Empirical evidence is also mixed regarding the impact of shareholder activism on the share price or efficiency of the target company.[31] Academics have often assumed that shareholder activism would enhance the efficiency of a company; therefore, there would be a share price increase. However, those scholars, even initially optimistic ones, became pessimistic about the capability of shareholder activism because of the limited effect that shareholder

[24] See, Roberta Romano, 'Public Pension Fund Activism in Corporate Governance Reconsidered' (1993) 93 *Columbia Law Review* 795; Miguel Rojas et al., 'Bringing about Changes to Corporate Social Policy through Shareholder Activism: Filers, Issues, Targets, and Success' (2009) 114(2) *Business and Society Review* 217.
[25] Dionysia Katelouzou, 'Worldwide Hedge Fund Activism: Dimensions and Legal Determinants' (2015) 17(3) *University of Pennsylvania Journal of Business Law* 790, 791.
[26] See Chapter 4.
[27] See note 1.
[28] Gillan and Starks (n 16) 60.
[29] See, note 3 and 4.
[30] Marco Becht et al., 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund' (2010) 23 *Review of Financial Studies* 3093; Alon Brav et al., 'Hedge Fund Activism, Corporate Governance, and Firm Performance' (2008) 63(4) *The Journal of Finance* 1729; Lucian Bebchuk, Alon Brav and Wei Jiang, 'The Long-Term Effects of Hedge Fund Activism' (2015) 115 *Columbia Law Review* 1085; Marco Becht et al., 'The Returns to Hedge Fund Activism: An International Study' (2015) *Working Paper N°. 402/2014*.
[31] See also, Gillan and Starks (n 16) 60-2 (Gillan and Stark summarised 36 empirical studies in the literature).

activism has had on share prices.[32] Third, shareholder activism may be related to corporate social responsibilities, which is likely to have less to do with shareholder wealth maximisation. As such economic efficiency argument could not shed a light on the desirability of shareholder activism.

Such studies could not therefore constitute an adequate intellectual basis for the reform discourse on the desirability of shareholder activism. Hirschman's influential book on feedback mechanisms in large organisations, *Exit, Voice, and Loyalty*[33] could, however, shed light on the role of shareholder activism in corporate governance, how it functions and whether or under what conditions it might be desirable. This could better inform lawmakers in preparing legal and regulatory proposals in this field. In general, his framework aims to identify the ways in which organisations varying from government to companies could avert decline and reach their full potential. His framework therefore complements the role of shareholders depicted by contractarians and brings new insight to the same situation.[34] Indeed, his framework and the traditional contractarian approach represent two different aspects of the same problem. It is a different perspective on contemporary activism.[35]

In Hirschman's framework, 'voice' refers to changes in the policy of an organisation through the appeal to a higher authority or different types of action including protests.[36] In this regard, voice could warn the board before it is too late. Shareholder activism, therefore, could function as an early warning mechanism that transmits shareholders' dissatisfaction with managerial policies about financial or

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[32] For example, Bernard Black, 'Shareholder Activism and Corporate Governance in the US' in Peter Newman (ed.), *The New Palgrave Dictionary of Economics and the Law* (Macmillan 1998) 459; Edward Rock, 'The Logic and (Uncertain) Significance of Institutional Shareholder Activism' (1991) 79 *The Georgetown Law Journal* 445.

[33] Hirschmann (n 5).

[34] Stephen Bottomley, *The Constitutional Corporation: Rethinking Corporate Governance* (Routledge 2007) 12 ('The corporate world is too complex and too variable for any single theory or discipline to be able to supply all of the answers to all of the problems of corporate governance. There are aspects of corporate life for which economic theories are well-suited but, equally, there are other aspects for which we need a different framework, another option on the conceptual menu. Economics can share the analytical stage with other approaches'); See also, Alessandra Arcuri, 'Eclecticism in Law and Economics', (2008) 1(3) *Erasmus Law Review* 60

[35] See Chapter 2; Bart Bootsma 'An Eclectic Approach to Loyalty-Promoting Instruments in Corporate Law: Revisiting Hirschman's Model of Exit, Voice, and Loyalty' (2013) 2 *Erasmus Law Review* 111, 125.

[36] Hirschman (n 5) 30.

social performance of companies. Shareholders must have sufficient tools to force the board to take on board their concerns, otherwise the board could ignore the voice to maintain the status quo in the name of long-termism or better performance in the future, which may never come. If the board take it seriously, the decline could be averted. While exit is closely related with economic behaviour, voice is closely associated with political behaviour.[37] Voice, therefore, might be related to the principles of allocative efficiency as well as to social and environmental issues. It refers to a process of articulation of interests directed at the management or at an authority (i.e. the board of directors) to which management is responsible, or through other means such as the media, campaigns or social media.[38] In the context of corporate governance, the role of shareholder activism is to express views and concerns to the board who can address them. It may entail an exchange of views about the company which could be carried out through formal means and/or informal means. It can be regarded as an attempt to change companies' strategies rather than to exit the company in the case of an unsatisfactory situation.

Voice could be used to reveal managerial errors or flaws in corporate strategy. Shareholders may not be happy with the financial or social performance of the company. These errors, which may not necessarily constitute breaches of duties, are often the real causes of corporate governance failures.[39] Voice could play a corrective function in the decision-making of corporations. In Hirschman's framework, there is no one single solution to the underperformance of organisations. There is no optimal mix of exit and voice for all organisations. Every organisation has its own optimal mix of exit and voice, which could also change over time. Voice can also be excessive for some organisations.[40]

To summarise, voice could help large organisations to recover from underperformance. In the corporate governance landscape, shareholder activism

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[37] Hirschman (n 5) 16.
[38] Hirschman (n 5) 3, 30.
[39] Hubert Ooghe and Sofie de Prijker, 'Failure Processes and Causes of Company Bankruptcy: a Typology' (2008) 46 *Management Decision* 305; Ryan Krause et al., 'Power to Principals! An Experimental Look at Shareholder Say-On-Pay Voting' (2014) 57 *Academy of Management Journal* 94.
[40] Hirschman (n 5) 70.

could, therefore, promote managerial accountability by functioning as a feedback mechanism. If activism is a genuine option for shareholders, we should question the belief that company law should be built on the assumption that shareholders prefer to exit a company and that voice is inherently detrimental to corporate governance. The question then becomes how shareholder activism should be accommodated within the US corporate governance framework.

3.2.2 Types of Shareholder Activism

3.2.2.1 Offensive and Defensive Types of Activism

In corporate governance, there are different types of shareholder activism depending on the objectives of shareholders. Cheffins and Armour introduced the first division in order to distinguish between different activism objectives. [41] The 'offensive' and 'defensive' activism distinction is based on the presence or absence of a pre-existing stake in a company.[42] There are also some differences in the methods of offensive and defensive activist shareholders, but shareholders that are offensive can adopt the methods of defensive activism and vice versa.

'Defensive' activism is mostly undertaken by mainstream institutional shareholders, namely pension funds and mutual funds to protect a pre-existing stake.[43] In the case of defensive activism, mainstream institutional shareholders with a pre-existing stake, but not enough to secure control, occasionally take action when they are dissatisfied with the performance of portfolio companies or their governance arrangements. In contrast, in the case of offensive activism, shareholders normally have no pre-existing shares, but accumulate a sizeable amount of a company's shares in the belief that the target company is underperforming and that the value of shares can increase as a result of activism, although not always in confrontational forms. These shareholders adopt a hands-on approach rather than waiting for the market to impose sanctions and are equipped to take action by persuading management or

[41] Brian Cheffins and John Armour, 'The Past, Present, and Future of Shareholder Activism by Hedge Funds' (2011) 37 *Journal of Corporation Law* 51, 56.
[42] Dionysia Katelouzou, 'Myths and Realities of Hedge Fund Activism: Some Empirical Evidence' (2013) 7(3) *Virginia Law & Business Review* 459.
[43] Katelouzou (n 42) 464.

shareholders to implement changes to increase shareholder returns. Cheffins and Armour state, ‘the readiness to take a hands-on role to shake things up is the crucial additional dimension’.[44]

Another key difference is that in offensive activism the shareholder seeks to receive ‘abnormal’ shareholder returns. In this context, offensive activism is ‘a profit-making strategy, they take economic positions in portfolio companies that enable them to engage in, and make profits from, activism.’ [45] Therefore, offensive activism is mostly performance driven activism, which aims to make significant changes to a company’s strategy.

Given the readiness of offensive activists to choose a hands-on approach and seek abnormal returns, offensive activism can be more accurately described as the market for corporate influence.[46] These investors use a sizeable share ownership to bring about change, and unlike takeovers, they do not aim to gain full control of a company. In this regard, offensive shareholder activism could be regarded as a softer substitute to the market for corporate control. However, this type of activism has prompted fierce debate and it can be argued that it has a dark side that raises concerns for corporate governance.[47] These arguments are important because they can direct lawmakers to constrain shareholder activism.

3.2.2.2 Responsible Shareholder Activism

In addition to the above classification, there is a further type of activism which not only focuses on financial and governance issues, but also on environmental, social and governance (ESG) concerns or in other words, sustainability issues. Shareholders can be dissatisfied with the social performance of a portfolio company just as they can with the financial performance of a company.[48] This thesis takes responsible activism

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[44] Cheffins and Armour (n 41) 58.
[45] Marcel Kahan and Edward Rock, ‘Hedge Funds in Corporate Governance’ in William Bratton and Joseph McCahery (eds) *Institutional Investor Activism* (OUP 2015) 151, 178-9.
[46] See Cheffins and Armour (n 41).
[47] Iman Anabtawi and Lynn Stout, ‘Fiduciary Duties for Activist Shareholders’ (2008) 60 *Stanford Law Review* 1255 1257; Kahan and Rock (n 45)188.
[48] Rojas et al., (24).

to mean the incorporation of stakeholder concerns with long-term value creation[49] and advancing social progress.

Recent developments in corporate governance seem to favour this approach.[50] There is also an increasing tendency for companies to show interest in stakeholder concerns and annual company reports often place substantial emphasis on non-shareholder interests.[51] A further point is that in the last twenty years, companies have started adopting codes of conduct that emphasise the stakeholder responsibilities of directors and managers, and establishing departments to examine the effects of a company's actions on stakeholders.[52] In short, there has been greater emphasis on long-termism and stakeholder concerns in company law and corporate governance.

These developments have normative implications for the behaviour of institutional investors and encourage them to adopt responsible investing principles. In fact, institutional investors have been shown an awareness of ESG issues and have been playing an active role in incorporating stakeholder practices in investee companies.[53] Hence, they are part of the corporate governance landscape.[54] In the US, a substantial number of shareholder proposals focus on social and environmental issues and the average support for these proposals has been increasing.[55] These proposals are concerned with a broader range of issues such as board diversity, International Labor Standards, human rights, sexual discrimination at portfolio

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49 David Hess, 'Public Pensions and the Promise of Shareholder Activism for the Sustainable Economic Development' (2007) 2 *Virginia Law & Business Review* 222, 223.

50 The United Nations Secretary-General *Principles for Responsible Investing* http://www.unpri.org/about-pri/the-six-principles/ .

51 Lisa Fairfax, 'The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms' (2006) 31 *The Journal of Corporation Law* 676, 691.

52 Fairfax (n 51), 694.

53 Anastasia O'Rourke, 'A New Politics of Engagement: Shareholder Activism for Corporate Social Responsibility', (2003) 12 *Business Strategy and the Environment* 227, 236; see also, Cynthia Williamst and John Conley, 'An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct', (2005) 38 *Cornell International Law Journal* 493; John Armour, Simon Deakin, and Suzanne Konzelmann, 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41(3) *British Journal of Industrial Relations* 531, 532.

54 O'Rourke (n 53) 227; Shuangge Wen, *Shareholder Primacy and Corporate Governance: Legal Aspects, Practices and Future Directions* (Routledge 2013) 148.

55 Randall Thomas and James Cotter, 'Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction' (2007) 13 *Journal of Corporate Finance* 368, 374; Michael Siebecker, 'A New Discourse Theory of the Firm after *Citizens* United' (2010) 79 *The George Washington Law Review* 161, 188.

companies, and the environmental impact of corporate actions.[56] The notable sponsors of this proposals are public pension funds and mutual funds,[57] but NGOs, labour unions, religious groups and social activists also submit these kinds of proposals.[58] Therefore, this type of activism can be considered the integration of business and societal concerns.[59] However, some public pension funds or religious groups can engage in activism for their own political or other purposes rather than the general interest of shareholders or the company.[60]

There are a number of factors that encourage institutional investors to adopt a responsible investing approach. Some funds regard responsible shareholder activism as a means of promoting the long-term sustainability of portfolio companies or the brand image of the fund.[61] These investors, in particular long-term investors such as pension funds,[62] have stronger incentives because negative publicity with regards to low social, environmental and labour standards could lead to brand damage and reduced value of portfolio companies. Institutional investors, in particular long-term ones, are more sensitive to bad publicity regarding the portfolio companies. Responsible investing could therefore serve a risk reduction function in corporate governance.[63]

Institutional investors might possibly focus on only the stakeholder aspect rather than the economic aspect of activism. [64] Some public pension funds and labour funds have been using shareholder activism to advance progressive social causes which were

[56] Rojas et al (n 48) 218-9.
[57] Rojas et al (n 48).
[58] Thomas and Cotter (n 55) 374.
[59] There is also a debate whether the emergence of responsible investment shifts the traditional shareholder primacy in the US and UK towards a more stakeholder-enhanced practice. For this discussion see, Wen (n 54) ch 5.
[60] Romano (n 24).
[61] Gordon Clark and Tessa Hebb, 'Why Should They Care? The Role of Institutional Investors in the Market for Corporate Global Responsibility' (2005) 37 *Environmental and Planning* 2015, 2029.
[62] Johnson and Greening found a positive relationship between pension fund activism and corporate social responsibility. See Richard Johnson and Daniel Greening, 'The Effects of Corporate Governance and Institutional Ownership Types on Corporate Social Performance' (1999) 42(5) *The Academy of Management Journal* 564.
[63] Marc Orlitzky and John Benjamin, 'Corporate Social Performance and Firm Risk: A Meta-Analytic Review' (2001) 40(4) *Business and Society* 369.
[64] See Iris H-Y Chiu, *The Foundations and Anatomy of Shareholder Activism* (Hart 2010) 14.

heavily criticised for not being related to shareholder wealth maximisation.[65] For instance, public pension funds may place emphasis on corporate decisions about local issues such as in-state employment, local plant closures or labour rights.[66] They can be found to be inconsistent with the general dynamics of corporate governance.[67] However, as will be seen in the following chapters, this kind of proposal could be beneficial in the decision-making process of the board.

As a conclusion, shareholder activism aims to change financial and non-financial corporate policies. The different types of activism are not exclusive to each other. Institutional shareholders could adopt a combination of these different types. So far, shareholder activism has been analysed as an accountability mechanism depending on private interests. However, there are also important policy developments imposing pressure on institutional shareholders to address short-termism in the market and to facilitate long-term investments in portfolio companies to ensure sustainability of companies. The following section will focus on this emerging aspect of shareholder activism.

3.2.3 Shareholder Activism and Public Interest

Shareholder activism was perceived as a means of ensuring the sustainability of companies and economy in general by addressing accountability problems in the corporate sector before the financial crisis. Therefore, it could be argued that there is an overlap between the private interests of institutional shareholders and the public interest. In the US, there is no single soft or hard law focussing on shareholder activism. The reasoning behind the codification process regarding shareholder empowerment could shed some light on how shareholder activism was perceived by US lawmakers. However, in the post-crisis era, the emphasis on shareholder activism as a means to address public interest concerns such as short-termism in the market and

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[65] Romano (n 24); Martin Lipton and Steven Rosenblum, 'Election Contests in the Company's Proxy: An Idea Whose Time Has not Come' (2003) 68 *Business Lawyer* 67, 78; see also, Randall Thomas and Kenneth Martin, 'Should Labor be Allowed to Make Shareholder Proposals' (1998) 73 *Washington Law Review* 41, 61.
[66] Romano (n 24) 797.
[67] Rodgin Cohen and Glen Schleyer, 'Shareholder v. Director Control over Social Policy Matters: Conflicting Trends in Corporate Governance' (2012) 26 *Noure-Dame Journal of Law, Ethics & Public Policy* 82, 84.

to insert long-termism into the market has become evident. The concept of stewardship was developed in the UK.[68] Such regulatory development in the UK affected some of the largest US institutional shareholders and they formed a framework, the Investor Stewardship Group (ISG), for corporate governance and stewardship.[69] This section will examine how shareholder activism was perceived by US lawmakers before the financial crisis, and then will analyse how the post-crisis developments affected major US institutional shareholders, and the importance of the stewardship movement in US corporate governance.

The Department of Labor's (DOL) Avon Letter of 1988 was a major landmark in the attempts to increase shareholder activism. The letter stated that 'the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies'.[70] The DOL issued Interpretative Bulletins (the IB 1994-1 and the IB 1994-2) on sections 402, 403 and 404 of the Employee Retirement Income Security Act (ERISA)[71] in 1994.[72] These sections regulate the voting of shares held in employee benefit plans and the investment and voting policy of the fiduciaries. The interpretative bulletins basically allowed social investing[73] and considered that in principle the voting of shares are in the scope of fiduciary duties of the plan's trustees and managers and found shareholder activism compatible with the ERISA if there is a reasonable expectation that such activities will increase the value of the investment in that company.

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[68] FRC, Stewardship Code (2012) < https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf>.

[69] The Investor Stewardship Group, < https://www.isgframework.org/> accessed 10 April 2017.

[70] Alan Lebowitz, 'Letter to Helmuth Fandl, Chair of the Retirement Bd., Avon Products, Inc.', (Feb. 23, 1988) quated in Paul Edelman, Randall Thomas, and Robert Thompson, 'Shareholder Voting in the Age of Intermediary Capitalism' (2014) 87 *Southern California Law Review* 1357, 1395.

[71] 29 USC Chapter 18; Public Law 93–406. ERISA is a federal law which establishes the minimum standards for the administration of private-sector pension plans, and fiduciary responsibilities of the plan trustees of managers. See, US Department of Labor https://www.dol.gov/general/topic/health-plans/erisa accessed 02 May 2017.

[72] 29 CFR 2509.94-1; 59 Fed. Reg. 32606 - Interpretive Bulletin Relating to the fiduciary standard under ERISA in considering economically targeted investments (social investing); 29 CFR 2509.94-2; 59 Fed. Reg 38863 - Interpretive Bulletin Relating to Written Statements Of Investment Policy, Including Proxy Voting Policy Or Guidelines.

[73] See Patrick Cross, 'Economically Targeted Investments – Can Public Pension Plans Do Good and Do Well?' (1993) 68 *Indiana Law Journal* 931.

The DOL amended these bulletins in 2008 in order to clarify its approach to social investing and the exercising of shareholder rights.[74] The Department adopted a relatively restrictive approach. Bulletin 2008-1 set forth that non-economic factors must be rare and, 'when considered, should be documented in a manner that demonstrates compliance with ERISA's rigorous fiduciary standards'. The 2008-2 Bulletin stated that fiduciaries have an obligation to refrain from voting if the cost of voting (including the cost of research to determine how to vote) exceeds the expected benefit. The 2008 IBs, therefore, established higher but unclear standards for managers and trustees when they incorporated the ESG factors and exercised voting rights. This situation made it difficult for managers and trustees to exercise voting rights and consider ESG factors because of the possibility of violating their fiduciary duties under ERISA. In this respect, they had a negative impact on shareholder activism.

The DOL once again revised the bulletins to address misperceptions regarding social investments and shareholder activism. The Department reverted to its approach in 1994 with small changes.[75] It removed the reference to the strict application of the cost-benefit analysis before voting and in so doing recognised more flexibility was needed by fiduciaries and encouraged them to consider whether any vote would impact on the value of the investment against the cost of casting shares. More importantly, in the preamble of the Bulletin, global corporate governance developments including the UK's Stewardship Code, the benefits of constructive activism, ESG factors and the problem of shareholder passivity in the wake of the financial crisis were accorded greater importance. This shows that the concept of stewardship has also influenced US lawmakers and encouraged them to loosen the criteria regarding shareholder votes and activism.

In line with the efforts of the DOL in 1994, the Securities and Exchange Commission (SEC) has adopted a similar rule which stipulates that voting is a matter

[74] 29 CFR Part 2509.08-1; 73 Fed. Reg. 61734 (17 October 2008) - Interpretive Bulletin Relating to Investing in Economically Targeted Investments; 29 CFR Part 2509.08-2; 73 Fed. Reg. 61731 (17 October 2008) - Interpretive Bulletin Relating to Exercise of Shareholder Rights.
[75] 29 CFR 2509.15-01; 80 Fed. Reg. 65135 - Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments; 29 CFR 2509.2016-01; 81 Fed. Reg. 95879 - Interpretive Bulletin relating to the exercise of shareholder rights and written statements of investment policy, including proxy voting policies or guidelines.

of fiduciary duty for the fund managers, mutual funds or similar entities holding votes for the beneficiaries.[76] The SEC also mandated that mutual funds disclose their proxy voting policies and how they exercise their proxy voting.[77] These developments reveal the agency cost concerns in the SEC and DOL and the possibility of the failure of voting, which is an important part of shareholder activism.

Institutional investors are seen to be able to influence the future of companies and, as a result, the future value of the shares held by beneficiaries who make savings for their education, housing needs or retirement. The corporate governance failures before 2003 gave investors renewed interest in corporate governance and revealed the need for institutional investors to be accountable: '[a]s major shareholders, mutual funds may play a vital role in monitoring the stewardship of the companies in which they invest'.[78] Therefore, the votes could increase the value of portfolio companies in general, thereby improving the financial position of the beneficial owners. Public interest is deemed to exist as a result of the cumulative effect of the increase in the performance of individual companies and total increase in the wealth of beneficial owners who are in fact long-term savers. It shows that the SEC wants to leverage shareholder activism as an accountability mechanism.

Moreover, in the wake of the 2007-2008 financial crisis, the Dodd–Frank Wall Street Reform and Consumer Protection Act was enacted [79] whose aim was 'to promote the financial stability of the United States by improving accountability and transparency in the financial system'.[80] This act introduced say on pay regulation in the US, and sought to provide shareholders with proxy access.[81] It seems that the recent financial turmoil has led US lawmakers and regulators to make an important change to shareholder empowerment in order to restore market trust. These approaches

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[76] SEC, Final Rule: Proxy Voting by Investment Advisers, Exchange Act Release No. IA-2106, 68 FR 6585 (7 February 2003) [[hereinafter referred to as 'Investment Advisers Act Release'].

[77] SEC, Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies Release Nos. 33-8188, 34-47304, IC-25922 (2003) [hereinafter referred to as 'disclosure of proxy voting release'].

[78] Section I of the Disclosure of Proxy Voting Release (n 77).

[79] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[80] The preamble of the Dodd-Frank Act.

[81] See, Chapter 5.

view shareholder engagement as a positive contributor to corporate governance, motivating and forcing shareholders to act as an accountability mechanism, to perform a quasi-stewardship role and a quasi-regulatory function. This might undermine the characteristic features of US corporate governance which is 'highly unusual in the extent to which it disenfranchises shareholders from both explicit and implicit influence'.[82]

Parallel to the shareholder empowerment debate, there are a number of bottom-up forces and market-driven demands for corporate governance standards and for a higher quality of shareholder activism. A new investor paradigm has been emerging in the US. The major institutional shareholders began developing a new paradigm for corporate governance in which they support long-term investment, engage with the board and management in the development of the strategy, and actively monitor the progress and support the management in their fights with activist funds where appropriate.[83] When the statements and letters of major institutional shareholders are examined, it becomes evident that they constantly emphasise that they are long-term investors to distinguish themselves from short-term investors, specifically activist funds. What has emerged is that long-termism and the well-being of the economy and society are the overarching themes in the emerging paradigm.[84]

[82] Martin Gelter, 'The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance' (2009) 50 *Harvard International Law Journal* 129, 134.

[83] Martin Lipton, 'Some Lessons from BlackRock, Vanguard, and DuPont' (*HLSFCGF*, 30 June 2015) https://corpgov.law.harvard.edu/2015/06/30/some-lessons-from-blackrock-vanguard-and-dupont/ accessed 20 February 2016.

[84] Martin Lipton, 'The New Paradigm for Corporate Governance' (*HLSFCGF*, 3 February 2016) < https://corpgov.law.harvard.edu/2016/02/03/the-new-paradigm-for-corporate-governance/ > accessed 20 February 2016.; Letter from Laurance Fink, CEO and Chairman of BlackRock to the CEOs of S&P 500 (1 February 2016) <http://www.wlrk.com/docs/CorpGovernanceLetter.pdf> accessed 27 March 2017; Letter from William McNabb, CEO and Chairman of Vanguard to CEOs of the investee companies (27 February 2015) <https://about.vanguard.com/vanguard-proxy-voting/CEO_Letter_03_02_ext.pdf> accessed 27 March 2017; Letter from CEO of State Street Global Advisors (SSGA) to the board members, (26 February 2016) < http://cecp.co/wp-content/uploads/2016/12/SSGAs_Letter_to_Directors_and_Guidelines_on_Effective_Independent_Board_Leadership.pdf?redirect=no> accessed 27 March 2017.

The Investor Stewardship Group published sets of *Stewardship Principles* and *Corporate Governance Principles*.[85] The concept of stewardship was first developed in the UK to deal with the problems of short-termism, excessive risk-taking, and investor myopia.[86] The 'stewardship' concept is based on the idea that shareholders 'need to earn at least implicit social legitimacy' in exchange for the privilege of limited liability.[87] The Financial Reporting Council (FRC) adopted the Stewardship Code.[88] The Stewardship Code places new responsibilities on asset owners and managers with the expectation of addressing agency problems in public companies and enhancing the sustainability of companies.

The Stewardship Code considers that stewardship is something more than only voting. Stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure and corporate governance including culture and remuneration.[89] Engagement is a purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings. Principle 1 of the Code requires institutional shareholders to disclose how they exercise their stewardship responsibilities. Under Principle 3, shareholder monitoring seeks to keep abreast of companies' performance as well as internal and external developments which could affect that performance. Principle 3 also requires that corporate governance arrangements be strong and effective, that general meetings be attended, and that voting power be exercised. Principle 4 urges institutional shareholders to escalate activism where necessary. Principle 4 of the Code does not limit instances of engagement to company strategy, governance,

[85] There have also been other corporate governance principles published in the US recently. Another coalition of institutional shareholders also issued the *Commonsense Principles of Corporate Governance*. See, Commonsense Corporate Governance Principles, < http://www.governanceprinciples.org/wp-content/uploads/2016/07/GovernancePrinciples_Principles.pdf> accessed 27 March 2017.
[86] FRC, Stewardship Code (2012) < https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf>
[87] David Walker, *Review of Corporate Governance in Banks and Financial Institutions* (2009) (hereinafter referred to as the 'Walker Review') Para 5.7.
[88] See Walker Review 17; The most recent version published in 2012, see FRC, Stewardship Code (2012) < https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf>.
[89] Principle 1 of the SC.

remuneration and risk, but also 'risks arising from social and environmental matters'.[90] The use of terms such as 'long-term success', 'responsibility', and 'transparency' emblematically indicate the nature of stewardship.[91] The Code allows investors to consider a more holistic view of corporate governance rather than mere financial performance. It may be argued that Principle 4 aims to create a normative model of investor culture which takes into account the long-term interests of companies, ESG issues, and the well-being of the economy. In short, shareholders are expected to act as a monitoring mechanism maximising shareholder value and a general accountability mechanism ensuring the long-term interests of society and economy in general.

Such an understanding of shareholder activism is also found in the Green Paper on Corporate Governance Reform published in 2016.[92] One of the main focuses of the Paper is executive pay, along with strengthening stakeholder voice in corporate boardrooms, and developing corporate governance in the UK's largest privately-held businesses. The UK government is of the view that executive pay causes significant public concern because it is disconnected from the pay of ordinary people and the long-term performance of companies. Green Paper considered possible changes to the executive pay framework by: enhancing shareholder voting rights; encouraging greater shareholder engagement; strengthening the role of remuneration committees, including by having greater engagement by shareholders and employees; enhancing transparency; and improving long-term incentive pay. In the Government Response to the Green Paper, the government decided to further increase the shareholder role in the executive pay regulation framework, broaden the role of remuneration committees, implement pay ratio reporting, introduce an enhanced transparency requirement for

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[90] Principle 4 of the Stewardship Code.

[91] The SC, p 1, 6 and 10.

[92] Department for Business, Energy & Industrial Strategy, *The Green Paper on Corporate Governance Reform* (November 2016) (hereinafter referred to as 'the Green Paper') < https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/584013/corporate-governance-reform-green-paper.pdf > accessed 18 February 2018 ; see also Department for Business, Energy & Industrial Strategy, *The Government Response to the Green Paper Consultation* (August 2017) < https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/584013/corporate-governance-reform-green-paper.pdf > accessed 18 February 2018.

the long-term incentive arrangements, and increase holding periods for share-based for share-based remuneration. This is a clear example of how contemporary shareholder activism is considered an accountability mechanism addressing public concerns and promoting the long-term interests of society and the economy in general.

The UK market also welcomed the Stewardship Code, which reached 302 signatories in 2015.[93] By examining numbers, it can be argued that the FRC had successfully encouraged institutional shareholders to adopt the SC.[94] UK institutional investors, acting through The Investment Association, published a report on the responsibilities of investors.[95] Indeed, the market takes the concept of stewardship seriously. Pensions and Lifetime Savings Associations has established a 'Stewardship Disclosure Framework'[96] to increase transparency of the enforcement of the stewardship principles by asset managers who confirmed to comply with the Stewardship Code. Yet, in 2014 the FRC itself acknowledged that there was an emerging engagement deficit in medium-sized companies and that many signatories have failed to do what the SC requires.[97] The FRC launched a tiering exercise to distinguish between signatories on the basis of the quality of their reporting against the Stewardship Code.[98] The tiering mechanism was intended to improve the quality of reporting and thereby confirm the commitment of institutional shareholders to the Code. The number of asset managers in Tier 1 was initially less than 20, but increased to 88 in 2016.[99] The tiering exercise achieved significant success in the improvement

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93 FRC, *Developments in Corporate Governance and Stewardship 2015* (January 2016) < https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewa-(1).pdf>.

94 FRC, *Developments in Corporate Governance: The impact and implementation of the UK Corporate Governance and Stewardship Codes* (December 2011) (hereinafter referred to as 'the Impact Report 2011') at 20 https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-2011-The-impa.pdf.

95 The Investment Association *Supporting UK Productivity with Long-Term Investment* (March 2016) http://www.wlrk.com/docs/SupportingUKProductivitywithLong-TermInvestment(March2016).pdf.

96 http://www.plsa.co.uk/PolicyandResearch/Corporate-Governance/Stewardship/Stewardship-disclosure-framework.aspx

97 FRC, *Annual Report and Accounts 2013/14* (2014) 16 < https://www.frc.org.uk/Our-Work/Publications/FRC-Board/FRC-Annual-Report-and-Accounts-2013-14-print-versi.pdf> accessed 20 May 2016.

98 FRC, *Developments in Corporate Governance and Stewardship 2016* (2017), 24 (hereinafter referred to as The 2016 Report) http://www.frc.org.uk/getattachment/ca1d9909-7e32-4894-b2a7-b971b4406130/Developments-in-Corporate-Governance-and-Stewardship-2016.pdf accessed 17 February 2018.

99 FRC (n 98) 24.

of reporting against the principles of the Code, but the FRC was still concerned about the signatories that reported poorly and did not engage with the FRC. The 2016 Report noted that many statements of institutional shareholders included more information about their environmental and social activities, along with executive remuneration. As a result, it is reasonable to conclude that the concept of stewardship is being increasingly embraced by the investment community in the UK, but the quality of stewardship still lags behind the expectations of the FRC even though a significant increase in the quality of signatory statements has been observed.

The concept of stewardship affected major institutional shareholders in the US. The promulgation of the stewardship principles and the development of an investor paradigm in the US could be one of the turning points in the history of US corporate governance. It is not only important because of the size of signatories (for instance, the ISG collectively covers nearly $17 trillion in assets under management),[100] but also because of its strong endorsement for constructive dialogue between the board and shareholders. Such activism goes beyond merely voting. These codes introduce to US corporate governance a principles-based framework. The ISG is of the view that 'the fiduciary responsibility of all asset managers' is 'to conduct themselves in accordance with the preconditions for responsible engagement in a manner that accrues to the best interests of stakeholders and society in general, and that in so doing they'll help build a framework for promoting long-term value creation on behalf of US companies and the broader US economy'.[101] The main intent is therefore to address public interest concerns of short-termism and to achieve long-term value creation for the ultimate beneficiaries, companies and the economy in general. Principle A of the Stewardship Principles stresses that institutional shareholders and their managers are responsible to their ultimate beneficiaries and should monitor beneficiary assets in a responsible manner. Principle B recommends that institutional shareholders disclose practices and guidelines on how they evaluate corporate governance factors including proxy voting and engagement issues. Investors are also recommended to dedicate resources to engaging with portfolio companies on corporate governance and other matters related to the long-term interests of the beneficiaries, and to disclose their monitoring

[100] The ISG (n 69).
[101] The ISG (n 69).

activities on a periodic basis if appropriate. Principle E requires investors to 'address and attempt to resolve differences with companies in a constructive and pragmatic manner'. Finally, institutional shareholders are encouraged to act collectively where appropriate. The US Stewardship Principles share many similarities with the UK Stewardship Code. The major difference between the US Stewardship Principles and the UK Stewardship Code is that while the latter was a regulatory response to the financial crisis, the former were a result of market demand for introducing long-termism in corporate governance and insulating companies from short-term pressures. The Stewardship Code and Stewardship Principles both emphasise the development of constructive dialogue and engagement in the investment strategies of institutional shareholders with the goal of facilitating sustainable long-term value creation, protecting the interests of the ultimate beneficiaries, sustaining the economy in general and ensuring other relevant sustainability issues.

In conclusion, shareholder voting has long been considered in the public interest and has been relied on by lawmakers to monitor companies. In particular, the recent financial crisis has emphasised shareholder activism, and the concept of stewardship has affected US institutional shareholders. The new investor paradigm and the Stewardship Principles aim to harden shareholder behavioural norms in a way in which shareholders could both monitor portfolio companies and address public interest concerns. They could also fundamentally recalibrate the relationship between US companies and institutional shareholders and make US corporate governance align with global practices. The promulgation of Stewardship Principles and the development of a new paradigm encourage companies and institutional shareholders and are particularly important for US corporate governance because they require companies and shareholders to work together in the development of business strategies, and direct companies to understand the preferences, expectations and policies of institutional shareholders. This type of activism in fact constitutes a middle ground between director primacy and shareholder primacy theories because this type of activism is more collaborative than the view of activism as assumed by the proponents of director primacy and shareholder primacy theories.[102] Moreover, the

[102] See, Matthew Mallow and Jasmin Sethi, 'Engagement: the Missing Middle Approach in the Bebchuk-Strine Debate' (2016) 12(2) *New York University Journal of Law and Business* 385.

interests of major institutional shareholders in the development of corporate strategies at portfolio companies, and their support for the long-term investment of companies are at odds with the role of shareholders as capital providers. Such constructive activism shows that not all types of shareholder activism focus on short-term returns. It could also support the board when activist proposals seek to extract value from the company.

3.3 Potential Problems with Shareholder Activism

Shareholder activism has so far been analysed as a positive attribute of corporate governance. This view, however, is not universally accepted and there are several important arguments against the active role of shareholders in corporate governance.[103] These arguments particularly depend on the idea that the participation of shareholders is inherently detrimental for corporations, other shareholders, and stakeholders. They have also been used to justify the insulation of board authority and to limit shareholder participation. This section succinctly examines these arguments[104] and investigates whether they establish a strong case for the board's and managers' insulation from shareholders.

3.3.1 The Short-Termism Argument

Following short-term interests at the expense of the company's long-term interests was recognised as a major problem in corporate governance even before the financial crisis and it has dominated corporate governance debates ever since.[105] It is also recognised that companies focus on short-term value rather than long-term value, and the effects

[103] Concerns with regard to short-termism existed even well-before the crisis. See Martin Lipton and William Savitt, 'The Many Myths of Lucian Bebchuk' (2007) 93 *Virginia Law Review* 733; Roberta Karmel, 'Should a Duty to the Corporation be Imposed on Institutional Shareholders?' (2004) 60 *The Business Lawyer* 1, 4–9.

[104] Dignam (n 8) 682; Christopher Bruner, 'Corporate Governance Reform in a Time of Crisis' (2010) 36 *Journal of Corporation Law* 309, 310.

[105] Martin Lipton, 'Takeover Bids in the Target's Boardroom' (1979) 35 *Business Lawyer* 101, 104; U.S. Senate, Subcommittee On Economic Policy, Committee On Banking, Housing, And Urban Affairs, *Short-Termism in Financial Markets* (111th Congress, 29 April 2010); Aspen Institute, *Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management* (2009) at 2; Dean Krehmeyer et al, *Breaking the Short-Term Cycle: Discussion and Recommendation on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value* (CFA, Center for Financial Market Integrity 2006); Kay Review 9, 14-20.

of short-termism are regarded as damaging to the well-being of the economy.[106] The short-termism view often holds that the average duration of shareholder investments, shareholder myopia, and shareholder activism are the major underlying reasons for short-termism problems in corporate governance and the market.[107] This view also shaped corporate governance reforms that would further protect boards and managers from shareholder influence and free managers and boards to follow long-term investment and business strategies.[108] This section will argue that the arguments for the short-term orientation of institutional investors are often misunderstood, and there are enough reasons to be sceptical about their validity. The short-term argument could not cast l2ight on the desirability of shareholder activism. Therefore, this thesis adopts a different approach and accepts 'right-termism'[109] rather than short-termism and long-termism.

Short-termism can be defined as the excessive focus of managers or institutional investors on short-term returns by neglecting its impact on the long-term value of companies such as reducing long-term investments.[110] Policy-makers consider that short-termism is inherently value-destroying, so shareholder myopia is often used to protect management from shareholder intervention. The widely held view is that the average shareholding period has decreased significantly in recent

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[106] Center for American Progress, *Report of the Commission on Inclusive Prosperity* (2015) at 35 < https://cdn.americanprogress.org/wp-content/uploads/2015/01/IPC-PDF-full.pdf>.

[107] Martin Lipton, 'Takeover Bids in the Target's Boardroom' 35 *The Business Lawyer* 101, 104; Martin Lipton, 'Takeover Bids in the Target's Boardroom A Response to Professors Easterbrook and Fischel' (1980) 55 *NYU Law Review* 1231, 1233-5; Martin Lipton and Steven Rosenblum, 'A New System of Corporate Governance The Quinquennial Election of Directors' (1991) 58 *University of Chicago Law Review* 187, 205-14; Martin Lipton, 'Twenty-Five Years After Takeover Bids in the Target's Boardroom: Old Battles, New Attacks and the Continuing War' (2005) 60 *The Business Lawyer* 1369, 1370-78; Leo Strine, 'One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?' 66 *The Business Lawyer* 1.

[108] Iman Anabtawi, 'Some Skepticism about Increasing Shareholder Power' (2006) 53 *UCLA Law Review* 561, 579-83; Martin Lipton and Paul Rowe, 'The Inconvenient Truth About Corporate Governance: Some Thoughts on Vice-Chancellor Strine's Essay' (2007) 33 *The Journal of Corporation Law* 63, 66-7; see also footnote 107.

[109] Jeffrey Gordon, 'Shareholder Activism, the Short-Termist Red-Herring, and the Need for Corporate Governance Reform' (*CLS* 28 March 2016) < http://clsbluesky.law.columbia.edu/2016/03/28/shareholder-activism-the-short-termist-red-herring-and-the-need-for-corporate-governance-reform/> accessed 30 April 2017.

[110] Lynne Dallas, 'Short-Termism, the Financial Crisis, and Corporate Governance' (2013) 37 *The Journal of Corporation Law* 265, 268.

decades and that the turnover of shares has increased dramatically.[111] Many vocal shareholders allegedly have short-term investment periods because they plan to hold shares for a short-time period and to sell after share price increases.[112] In theory, these investors care only about short-term price changes rather than the long-term interests of the company, so they are blamed for being narrowly focussed on short-term share returns and quarterly results.[113] Consequently, these shareholders are assumed to place pressure on management 'to pursue myopic business strategies that don't add lasting value,' and to 'raise share price[s] just long enough that [the institution] can sell and move on to the next stock that might see a short-term bump in its stock'.[114] This arguably jeopardises the long-term performance of companies and the sustainability of the economy, and so leads to sub-optimal returns for ultimate beneficiaries;[115] hence shareholder activism is often associated with short-termism in corporate governance and value-destroying corporate strategies.[116]

The traditional account of the short-termism argument has broader implications for corporate governance debates because it is often used to justify insulating boards and managers from shareholders,[117] and deployed in favour of limiting the role of shareholder activism in corporate governance. Views that use shareholder myopia to justify managerial and board autonomy have long persisted in corporate governance discourse,[118] and have influenced judges of the Delaware Supreme Court. Justice Strine, now the Chief Justice of the Delaware Supreme Court, regarded shareholder short-termism as a 'substantial policy dilemma',[119] and argued that:

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[111] Mark Roe, 'Corporate Short-Termism - In the Boardroom and in the Courtroom' (2013) 68 *The Business Lawyer* 977, 998; Dignam (n 8) 684.
[112] See, US Senate (n 105); Iman Anabtawi, 'Some Skepticism about Increasing Shareholder Power' (2006) 53 *UCLA Law Review* 561, 564, 583.
[113] Anabtawi (n 112) 583.
[114] Lynn Stout, *The Shareholder Value Myth* (Berrett-Koehler publisher, 2012) 67.
[115] See, US Senate (n 105); Anabtawi (n 112) 564, 583.
[116] Lipton and Savitt (n 103) 746.
[117] Lucian Bebchuk, 'The Myth That Insulating Boards Serves Long-term Value' (2013) 113 *Columbia Law Review* 1637,1639.
[118] See footnote 107 .
[119] Leo Strine, 'One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless their Powerful Electorates also Act and Think Long-term' (2010) 66 *The Business Lawyer* 1, 2.

> 'it is jejune to demand that CEOs and boards manage for the long term when the stockholders who can replace them buy and sell based on short-term stock price movements, rather than the long-term prospects of firms'.[120]

It becomes clear from the arguments above that the short-termist pressure could be transmitted to management in two ways. First, the market could be overvaluing short-term corporate strategies; otherwise, the traditional short-termism argument would not make sense because it assumes that short-term investors are guided by short-term price changes which jeopardise the continuing existence of companies. Second, activist or vocal funds are capable of undermining managerial authority by directing management towards value-reducing strategies.

With regards to the first factor, in order for the short-termism argument to hold water, short-term corporate strategies must be overvalued in the market, i.e. they must be mistakenly viewed in a positive light. However, the market erroneously overvalues different sectors as happened in the dot com bubble. This serves as an example of stock market long-termism because 'the market was valuing firms with no immediate prospect for strong earnings as very good investment prospects.'[121] Moreover, the market does not always favour short-term corporate strategies. There are also industries such as oil production companies that require large sums of long-term investment. These companies have little difficulty attracting investment from investors for their projects.[122] These examples indicate that the market has the potential to favour long-term corporate strategies, depending on features of particular corporate sectors. The first factor in the short-termism argument is not enough to justify managerial insulation.

With regard to the second factor, some shareholders might have short-term preferences. They could use shareholder activism to encourage the board and management to follow short-term investment strategies. This is often associated with the time horizon of investors. However, institutional investors have different investment horizons. It is therefore difficult to draw a general conclusion based on the

[120] Strine (n 109) 17.
[121] Roe (n 111) 995.
[122] Roe (111) 996.

extreme short-term holding periods of some investors. Indeed, there is some evidence documenting decreases in holding periods.[123] Program traders can transfer shares in seconds now.[124] However, apart from these program traders, the holding periods for the mainstream institutional shareholders have not changed in the last 25 years. Moreover, the average holding period has increased.[125] Even for hedge funds, the average holding period is between one and two years.[126] Extreme short-termist investors like day traders do not constitute a threat to corporate governance because these investors just seek opportunities to exploit pricing anomalies, and their view is too short to have an impact on company policies. Therefore, extreme short-termism does not constitute a problem for corporate governance.

Institutional shareholders, other than day traders, are the parties who could use shareholder activism to influence the board and management to follow short-term corporate strategies. They could possibly induce management to follow arguably value-reducing corporate strategies, which provide short-term spikes in share prices,[127] but destroy the long-term value of the company.[128] The empirical evidence is inconclusive here because there are also studies that find that the increase is not reversed following activism.[129]

Criticising or praising a corporate strategy as short-term or long-term misses the core point; the issue is the right-term for value creation, and this may require

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[123] Patrick Bolton and Frédéric Samama, 'Loyalty-Shares: Rewarding Long-Term Investors' (2013) 25 *Journal of Applied Corporate Finance* 86.
[124] Leo Strine, 'One Fundamental Corporate Governance Question We Face : Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term ?' (2010) 66 *The Business Lawyer* 1, 11.
[125] Roe (n 111) 1000.
[126]Katelouzou (n 43), 464.
[127] Indeed, share price increases in the market have been observed following activism (see, n 30).
[128] Martin Lipton and Steven Rosenblum, 'Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come' (2003) 59(1) *The Business Lawyer* 67, 78.
[129] Lucian Bebchuk, Alon Brav, and Wei Jiang, 'The Long-term Effects of Hedge Fund Activism' (2015) 115 *Columbia Law Review 1085*; Marco Becht et al., 'The Returns to Hedge Fund Activism: An International Study' (2017) 30(9) *Review of Financial Studies* 2933; Sunil Wahal and John McConnell, 'Do Institutional Investors Exacerbate Managerial Myopia?' (2000) 6 *Journal of Corporate Finance* 307 (Wahal and McConnell conducted research on firm-level expenditures for long-term investment for over 2500 US companies and concluded that there is 'a positive and statistically significant relation between industry-adjusted PP&E [property, plant and equipment] and R&D expenditures and the fraction of shares owned by institutional investors').

companies to be run in pursuit of short-term objectives. As noted above, long-term projects requiring massive investments are successfully carried out by large public companies such as oil companies, but companies operating in very competitive sectors may not have the same long-term investment opportunities, given the speed of technological changes and increasing globalisation. Hence, short-term strategies proposed by shareholders or short-term warnings through share price changes could be efficient recuperation mechanisms for some companies.[130] The upshot is that shareholder short-termism may not be a problem unless it causes the board and management to make value-destroying choices.

The desirability of shareholder activism cannot, therefore, be determined in the context of the short-termism and long-termism debate. As will be discussed in Chapter 4, some changes in corporate strategies proposed by activist funds could be highly controversial and radical, such as the departure of the CEO, the restructuring of the company, or the distribution of dividends, and these proposed strategies could easily be considered to come at the expense of the long-term value of companies. In essence, these changes are alternative strategies to those applied by the incumbent boards and managements. Depending on company-specific circumstances, alternative corporate strategies proposed by shareholders could be useful to address accountability and agency problems. Therefore, the right-term, which is an investment horizon that is suitable for a particular company and which creates value, could be a short-term one for some companies. Boards and managers should not be able to freely dismiss such alternative strategies because of the short-termism approach, as in doing so, they might disregard potentially value-enhancing alternative strategies. The real issue is the conflict between different views of shareholders, managers and directors regarding how long the investment horizon of a company should be.[131] There is no single answer to this question, and the answer depends on company-specific circumstances.

In conclusion, conflicting empirical evidence and theoretical arguments have cast doubt on the transmission of short-termism through the average investment

[130] Hirschman (5) 127.
[131] See, Alessio Paccess, 'Exit, Voice, and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance' (2016) 4 *Erasmus Law Review* 199.

duration of shareholders, shareholder myopia, and shareholder activism. Given the contradictory empirical and theoretical evidence, short-termism argument cannot be used as a justification for the insulation of a board from shareholder engagement. Thus, rather than framing the debate between the short-term or long-term, the focus should be on the value-creation and any shareholder perspectives, even ones seeking to shorten the investment duration, should be seen as an alternative strategy.

3.3.2 The Conflicting Interests of Shareholders

Another argument for the case against shareholder activism is the heterogeneous interests of shareholders and the possibility of a conflict of interest between shareholders and a company. The law and economics literature has been sceptical about the frequency of shareholder activism, but some institutional shareholders might use activism to advance their own interests at the expense of other shareholders, i.e. not all shareholders are interested in maximising shareholder value.[132] In other words, some shareholders could pursue non-economic goals.

Public pension funds and labour unions are often criticised for pursuing non-economic targets. These funds could have incentives to further special employee interests or to pursue the political interests of fund managers at the expense of other shareholders' interests, or to follow an explicit social agenda. For instance, they could decline a takeover bid just to protect local employment or to focus on labour rights. It is therefore argued that these investors could use their power to engage in social investing and to extract private benefits which are at odds with the economic goals of companies.[133] The fact that shareholders have divergent interests has been used for managerial insulation to protect shareholders from each other and to freely adopt long-term business strategies.[134] However, it should be borne in mind that these investors are also subject to the same fiduciary duties as other institutional investors and within the boundaries of such duties, they are allowed to invest in socially or economically

[132] Anabtawi (n 8) 574.
[133] Stephen Bainbridge, *The New Corporate Governance* (OUP 2008) 228-30; see also, Brett McDonnell, 'Professor Bainbridge and the Arrowian Moment A Review of the New Corporate Governance in Theory' (2009) 34 *Delaware Journal of Corporate Law* 139, 176.
[134] Anabtawi (n 8) 564; Stephen Bainbridge, 'Director Primacy and Shareholder Disempowerment' (2006) 119 *Harvard Law Review* 1735, 1754.

targeted projects that are beneficial to employees as long as the risk undertaken is similar to those of other projects.[135]

Case law, constituting the foundation of director primacy in the US, allows or requires the board of directors to take into consideration other stakeholders' concerns.[136] If the board is allowed to consider other stakeholders, then shareholder-initiated proposals aiming to protect their interests or force management to consider stakeholders' concerns should not be a major problem, since public pension funds and labour unions are trying to protect the interests of employees or may be interested in other issues such as the environment. In this regard, these proposals are likely to be consistent with the general approach of company law.

3.3.3 Risk Decoupled Shareholders

Institutional shareholders could decouple voting rights from the economic ownership of shares.[137] This causes corporate governance concerns because shareholders could obtain more voting power than their economic ownership or hide their economic ownership. This gives rise to the possibility that they could influence the board in light of their own private interests. In general, there are two types of risk-decoupling strategies: negative risk-decoupling and positive risk-decoupling. In the case of negative risk-decoupling, shareholders usually maintain the formal shareholder position, i.e. voting rights, but limit their exposure to share price changes. The positive risk-decoupling, however, allows shareholders to have greater economic interests than voting rights. In particular, activist funds have recognised the potential of financial instruments to increase their voting power without having to bear the economic risks

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[135] Stewart Schwab and Randall Thomas, 'Realigning Corporate Governance: Shareholder Activism by Labor Unions' (1998) 96 *Michigan Law Review* 1018, 1080.

[136] In the *Unocal* case, the Court of Delaware allowed the board to have regard to the impact of a takeover bid on 'constituencies other than shareholders.' See *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946, 955 (Del. 1985). In Chapter 2 it was shown that in other states in the US, there are a number of anti-takeover statutes which give power to the board to consider other stakeholder concerns.

[137] Henry Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 *Southern California Law Review* 811, 815.

of their actions or enhancing their economic interests in a target companies without disclosing it.[138]

The primary aim of negative risk-decoupling transactions is to keep all formal shareholder rights and to limit the economic consequences of the use of voting rights.[139] Negative risk-decoupling could be implemented in various ways such as via future contracts, equity swaps, forwards, puts or calls, or share lending. These strategies are regarded as 'the artificial decoupling of risk and influence in shares of portfolio companies' to limit the economic risk which is in fact inherent in the shares.[140] This is often called 'empty voting' because the shareholder has voting ownership, but the voting rights have been emptied of the economic ownership.[141]

A prominent example of this phenomenon is the case of *High River Ltd v Mylan Labs, Inc* which occurred in the acquisition of King Pharmaceuticals ('King') by Mylan Labs ('Mylan').[142] In 2004, Mylan announced its intention to acquire King Pharmaceuticals ('King') at a substantial premium over King's trading price. Perry, a hedge fund, had significant share ownership in King and would benefit from the acquisition; Perry would make almost $28 million profit because of the premium that Mylan would make.[143] The acquisition was not found to be in the interests of Mylan and was opposed by some of Mylan's shareholders including Carl Icahn.[144] Perry accumulated almost 10 per cent of Mylan's shares to increase the likelihood of the acquisition, but at the same time it engaged in a series of swap transactions to limit the economic risk of having Mylan's shares. As a result, Perry obtained voting rights which were equal to 10 per cent of Mylan's outstanding shares without the economic risk of having the shares. Here, it appears evident that the interests of Mylan and Perry

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138 Wolf-Georg Ringe, 'Hedge Funds and Risk Decoupling: The Empty Voting Problem in the European Union' (2012) 36 *Seattle University Law Review* 1027.
139 Wolf- Georg Ringe, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance* (OUP 2016) 28.
140 Ringe (n 138) 1032.
141 Henry Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2005) 79 *Southern California Law Review* 811.
142 *High River Ltd. P'ship v. Mylan Labs., Inc*., 353 F. Supp. 2d 487 (US District Court. M.D. Pennsylvania 2005).
143 Hu and Black (n 141) 828.
144 Ringe (n 139) 32.

were in conflict with each other in relation to the proposed merger. Perry was able to vote for the acquisition– without being subject to share price changes – to make substantial profit through its shares in King even though it was against the interests of Mylan and its shareholders.

The negative risk-decoupling techniques give rise to governance concerns because these techniques also affect the core assumptions behind share ownership and voting rights.[145] Shareholders, who employed these strategies, could have different risk profiles than ordinary shareholders; thus, they could be more or less risk-averse than other shareholders. In the traditional view, shareholders – as the residual claimants of a company – have the greatest interest in increasing shareholders' value, so shareholders exercise voting rights in a way that would increase the company's value. The underlying logic is that shareholders usually hold proportionate voting rights to their cash flow rights. Where this is broken, Easterbrook and Fischel argue that it causes another type of agency cost between shareholders and these shareholders may not make optimal decisions.[146] Having more voting rights than economic ownership or the reverse might distort the incentives of shareholders. Compared to other shareholders, risk-decoupled shareholders could be more risk friendly. These shareholders could possibly aim to obtain the private benefits of control which are not usually shared with other shareholders.

Negative risk-decoupling techniques, however, play a role in the functioning of corporate governance and the market. Short-selling could help to bridge the gap between overvalued shares and the real value of shares.[147] Short-selling could be beneficial by discovering and conveying new information about the underperformance of companies and financial misconduct to the market in correcting share prices.[148] It

[145] It was assumed that the voting rights and equity interests could not be separated because voting rights and financial interests are inherently combined in shares. See Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (Harvard 1991) 74.
[146] Frank Easterbrook and Daniel Fischel, 'Voting in Corporate Law' (1983) 26 *The Journal of Law and Economics* 395, 409.
[147] Jennifer Payne, 'The Regulation of Short Selling and Its Reform in Europe' (2012) 13 EBOR 413, 418.
[148] Jonathan Karpoff and Xiaoxia Lou, 'Short Sellers and Financial Misconduct' (2010) 5 *The Journal of Finance* 1879.

could also enhance market efficiency and help the market in increasing liquidity and trading opportunities.[149] Therefore, they also play a role a role in addressing collective action problems and in enhancing efficient monitoring over management in the interests of all relevant shareholders. So, any reform call must be approached with caution and should be neither too restrictive nor too broad.

Positive risk-decoupling is different from negative risk-decoupling. This method is preferred by investors when they seek to avoid the disclosure requirements of share ownership. It is quite possible for an investor to change its hidden ownership to actual voting power.[150] Financial derivatives called contracts for difference (CfD) are widely used in order to effectuate the positive risk-decoupling. By using CfDs, investors gain the ability to obtain de facto economic ownership without becoming official owners of the shares. In traditional CfD agreements, there are two parties: the long party and the short party. In principle, the long party agrees to pay the short party interest that accrues at a rate determined by the parties on the value of the shares and an arrangement fee in exchange for share price increases and any financial benefits distributed by the company to the short party.[151] In return, the long-party obtains economic benefits as if it were the owner of shares, but without the need to financing such a purchase directly. The investment is smaller than the actual value of the shares, yet it does still serve the same economic function.[152]

While CfD does not provide any voting rights to the investor, it is in fact a powerful tool for investors to obtain influence over management with a small investment. The short parties, usually investment banks, have no interest in voting rights attached to the shares.[153] However, the banks seeking to attract swap business may prefer to vote in line with their clients, i.e. long parties in order to be attractive to clients. The long party could potentially have influence over the shares which it does

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[149] FSA, *Short-Selling* (February 2009) Discussion Paper No 09/01 ch 3.

[150] Henry Hu and Bernard Black, ‘Empty Voting and Hidden (Morphable) Ownership’ (2006) 61 *Business Lawyer* 1011, 1016.

[151] *CSX Corp. v. Children's Investment Fund Management (UK)* LLP, 562 F.Supp.2d 511, 520 (S.D.N.Y.2008).

[152] Ringe (n 139) 60.

[153] Ringe (n 139) 64.

not own, and shares are exercised by the party who does not have any economic interest in the future of the company.

Overall, risk-decoupling strategies cause concerns in the market and corporate governance. Risk-decoupled shareholders could have more influence than economic ownership or vice versa and could aim to extract private benefits and to avoid disclosure regimes. These transactions that decouple voting rights and economic ownership of shares dilute the efficacy of shareholder voting and constitute a 'real threat to the basis of shareholder franchise,'[154] that is, shareholders bear the greatest residual risk. However, these strategies also serve important functions in corporate governance. Therefore, these strategies could sometimes be useful based on the circumstances. So, any regulatory attempts should adopt a balanced approach rather than a complete ban and take into account the beneficial effects of these strategies as well as the potential problems that could arise.

3.3.4 Stakeholder and Team Production Theories

Shareholder activism is also criticised by the defenders of stakeholder theory. This theory has been developed by many writers from different perspectives and therefore it is impossible to provide a unitary explanation. Nonetheless, it will be examined according to its relevance to shareholder activism.

Proponents of the stakeholder theory generally argue that the objective of corporations should be construed broadly and include the well-being of stakeholders other than shareholders, and should not be confined to the interests of shareholders alone.[155] It places stakeholders at the centre of the corporation and considers them as 'ends' rather than 'means'; thus, they must have a say in the future direction of the corporation in which they hold stakes.[156] Since this theory considers a company as 'a team of people who enter into a complex agreement to work together for their mutual

[154] Edelman et al (n 70) 1406.
[155] Thomas Donalson and Lee Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications' (1995) 20:1 *The Academy of Management Review* 65, 70.
[156] Andrew Keay, 'Stakeholder Theory in Corporate Law: Has it got what it takes' (2010) 9(3) *Richmond Journal Of Global Law & Business* 249, 254.

gain'[157] instead of prioritising only the interests of shareholders, all stakeholders in the corporation are valuable and they should be treated as such by the management of the company. The theory argues that shareholder primacy obstructs non-shareholders from making firm-specific investments because they are aware that their investments will only be used for shareholders.[158] Likewise, Zingales argues that human capital is the most important asset in modern companies.[159] As a result, according to this theory, all stakeholders bear residual risk and their interests are bound to the company.

A shift in accountability from shareholders to a broad range of stakeholders is an inevitable consequence of this theory. Concerning stakeholder theory, Stout and Blair introduced team production theory that characterised the board as a mediating hierarchy that considers the interests of all stakeholders and facilitates the production by coordinating the contribution of different stakeholders in public companies.[160] This model challenges the norm of shareholder primacy as it advances the view that directors and managers have a duty to create optimal value for all stakeholders who affect or are affected by the actions of a company. Therefore, it aims to include other stakeholder concerns in the decision-making process. This stakeholder focus, it is argued, would increase the wealth of shareholders in the long run. Corporate governance therefore becomes (or should be) open and responsive to 'the rights and wishes of stakeholders'.[161]

Although it is not one of the primary aims of this thesis to examine what corporate objectives should be, this theory has some significant shortcomings. First of all, it seems very difficult for the board to perform the mediating role which is a core aspect of this theory because management leaves little room for the board.[162] Indeed, Chapter 2 of the present thesis demonstrated the potential problems with regard to

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[157] Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia Law Review* 247, 278.
[158] Margaret Blair and Lynn Stout, 'Director Accountability and the Mediating Role of the Corporate Board' (2001) 79 *Washington University Law Quarter* 403, 404.
[159] Luigi Zingales, 'In Search of New Foundations' (2000) 55 *Journal of Finance* 1623, 1642.
[160] Blair and Stout (n 157) 253-4, 271-2.
[161] Adu Demb and Friedrich Neubauer, 'The Corporate Board: Confronting the Paradoxes' (1992) 25 *Long Range Planning* 9.
[162] Brian Cheffins, 'The Team Production Model as a Paradigm' (2015) 38 *Seattle University Law Review* 397.

independent directors. Here, it seems less likely that such a board could play the final arbitrator role when there is a dispute between managers, shareholders, employees or other stakeholders. Therefore, it is doubtful that the board could play the role envisaged by the theory.

Second, the theory creates a stereotypical image of shareholders. It connects business failures with the concept of shareholder primacy. It does not seem realistic to establish a connection between extremely destructive actions and shareholder value and it is even less likely anybody would encourage such action. Furthermore, directors and managers are in fact given enough freedom to ignore such situations.[163] The *Deepwater Horizon* disaster is taken as an example in Stout's book to establish a link between shareholder value thinking and failures, due to the fact that the project was behind schedule, $60 million over budget and safety requirements were ignored.[164] The reasoning behind this argument is simple and obvious, namely that shareholders forced management to focus on short-term returns and management ignored safety requirements. However, it is much complex than this simple causation. The National Commission on *Deepwater Horizon* identified different problems including engineering mistakes, management failures, inadequate safety measures by companies and technological difficulties in deep-water drilling.[165] The company failed to protect shareholder value to the extent that shareholders, including UK institutional investors, sued BP and other companies on the grounds of misrepresentation and failure to protect shareholder wealth.[166]

Given the impracticability of this theory, this thesis argues that shareholder activism can be reconciled with stakeholder concerns. It can become a mechanism in which other stakeholder concerns can be transmitted to the board room. As examined above, responsible shareholder activism internalises stakeholder concerns and places

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163 It will be demonstrated in Chapter 5 that the board is given authority to manage company.
164 Stout (n 114) 1.
165 Oil Spill Commission, *Oil Spill Commission Landmark Report on Gulf Disaster Proposes Urgent Reform of Industry and Government Practices to Overhaul US Offshore Drilling Safety* (Press Release, 11 Jan 2011) http://oceanleadership.org/wp-content/uploads/2011/01/Final-Report-Press-Release.pdf accessed 25 February 2016.
166 See *Avalon Holdings, Inc., Et Al. v BP p.l.c., et al.* No: 4:12-cv-3715 (US District Court Southern District of Texas, 30 Sep 2013) (MDL 2185 Docket No. 1022).

pressure on the board and management to address stakeholder concerns. For example, in 1991, Cracker Barrel announced that it would not employ people who fail to demonstrate heterosexual values after which it fired homosexual employees.[167] However, a shareholders' proposal to remove the company's employment policy was not even put to the vote of shareholders due to proxy regulation in the US.[168] In 2002, shareholders again took action to remove this employment policy and this time more than half of shareholders voted in favour of the shareholders' proposal. Now, more than 85 % of Fortune 500 companies have employment policies against discrimination.[169] Institutional shareholders submitted a large volume of proposals concerning the use of chemicals detrimental to human health.[170] Similarly, shareholders submitted to abolish racial segregation on Greyhound's buses in 1952.[171] In these examples, it can be seen that shareholder activism is not inherently detrimental to the interests of stakeholders. On the contrary, with the help of activism, corporate social responsibility or responsible activists enable stakeholders' concerns to be given consideration by the board. Therefore, shareholder activism is not incompatible with stakeholder theory. It could be used to enhance stakeholder concerns in the decision-making structure of public companies if shareholders are given voice in companies.

3.3.5 Concluding Remarks

There are important arguments invoked for justifying the board's insulation from shareholder participation. In particular, shareholders' investment horizons and their private interests generate short-termism and excessive risk-taking, which were found to be major factors behind corporate governance failures. With regards to the short-termism argument, this thesis has shown that the short-termism and long-termism debate cannot shed light on the desirability of shareholder activism. Even though some objectives of shareholders could raise concerns that they sacrifice the long-term value of the company for the short-term interests of shareholders, they should be evaluated in the context of the right-termism approach. Right-termism requires companies to

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167 *New York City Employees' Retirement System (NYCERS) v. SEC, 45 F.3d 7* (2d Cir 1995).
168 This will be discussed in Chapter 5; Margaret Sachs, 'Social Proposals Under Rule 14a-8: A Fall Back Remedy in an Era of Congressional Inaction' (2012) 2 *UC Irvine Law Review* 931, 938.
169 Sachs (n 168) 939.
170 Sachs (n 168) 940.
171 *Peck v. Greyhound Corp*. 97 F. Supp 679 (S.D.N.Y. 1951).

pursue an investment and planning horizon that, could be short-term or long-term, but is suited to company-specific circumstances and creates value for the company. The analysis demonstrated that in general the heterogeneity of shareholders' interests does not raise corporate governance concerns. However, shareholders could decouple voting rights from the economic ownership of shares. Therefore, they can increase their voting power without bearing the economic risk of their decisions or enhancing economic interests without disclosing economic ownership. With the help of risk-decoupling techniques, shareholders could use their influence to support risky business strategies that would deliver abnormal returns.

Insulating the board and management from shareholders would discard and reject the value of shareholder activism to corporate governance permanently because of only a risk that some shareholders could use their influence for their own private and short-termist interests. Even if managerial insulation from shareholders and the market would address the problem of short-term investors and shareholders with private interests, it would create direct agency cost problems. When management can freely dismiss feedback from shareholders and the market in the name of long-termism or informational advantage, it creates other unintended costs. Even if there is a possibility of a detrimental impact of shareholder activism, the solution is not a managerial insulation from shareholder activism, given accountability problems and other unintended consequences. Therefore, managerial insulation does not seem to be an appropriate solution to the concerns discussed above.

3.4 Conclusion

This chapter has found shareholder activism overall beneficial for corporate governance, despite its potential drawbacks. Shareholder activism i.e. voice could be used as an accountability mechanism in corporate governance. It functions as an early warning mechanism and provides the board with feedback regarding financial and non-financial corporate policies. It is argued that empirical evidence cannot shed light on the desirability of shareholder activism. Hirschman's framework revealed the real issue related to diverging views about the corporate policies or the right time horizon to maximise shareholder value. In this framework, long-termism is not always useful for all companies because some companies benefit from an immediate response from the market. Moreover, long-termism could be used by the board and management to hide the underperformance of companies. In addition, shareholder activism could be excessive for companies too. Therefore, companies should be able to adjust the level of activism according to their needs.

In the post-crisis era, shareholder activism is increasingly conceived as a private sector solution to address public interest concerns such as short-termism and to ensure the sustainability of companies and the economy in general. The concept of stewardship has been developed to establish constructive engagement between the board and shareholders to address short-termism and attacks from activist funds. This is a promising development in US corporate governance because it constitutes the middle ground between shareholder primacy and director primacy.

While this thesis is of the view that the short-termism and long-termism debate cannot elucidate the desirability of shareholder activism, it notes the potential problem regarding risk-decoupling techniques. By using risk-decoupling techniques, some shareholders could pursue strategies to extract private benefits that are not shared by other shareholders. This study also considers shareholder activism as compatible with stakeholder theory. In fact, responsible shareholder activism, the stewardship principles, and the emerging investor paradigm supports this argument. Overall, the potential problems regarding shareholder activism do not provide persuasive normative implications for insulating the board. The potential benefits of activism to companies and the market appears to be higher than its potential costs or misuses.

Chapter 4. The Landscape of Institutional Shareholders

4.1 Introduction

This chapter aims to examine the features and types of institutional investors and how the evolving landscape of institutional shareholders affects shareholder activism. Chapter 3 has demonstrated that shareholders are now expected to act as an accountability mechanism for their own interests, as an accountability mechanism for the long-term interests of the ultimate beneficiaries and companies, and for the sustainability of the economy and society in general. It has also highlighted the possibility that shareholder activism could be used to extract private benefits from the company and other shareholders. The monitoring capacity of mainstream investors is therefore of considerable importance. This section will examine the business models of institutional investors, with a focus on their monitoring capacity.

Much of the story about the emerging role of shareholders is related to the increase in institutional share ownership and the features of different types of institutional shareholders.[1] The structure, incentives and behaviour of institutional shareholders are different from each other; institutional shareholders are not a homogenous group. With the growth of institutional ownership, some institutional shareholders took an active stance in corporate governance, but most of them were reluctant to take a hands-on approach in the management of portfolio companies.[2]

Hedge funds also became important share owners and they perceive shareholder activism as an investment strategy.[3] Hedge fund activism contains many complexities. On the one hand, they hold management accountable and lead other shareholders because they are less subject to rational shareholder passivity. In this

[1] Serdar Celik and Mats Isaksson, 'Institutional Investors and Ownership Engagement' (2013) 2 *OECD Journal: Financial Market Trends* 93, 94.
[2] See for instance, Edward Rock, 'The Logic and (Uncertain) Significance of Institutional Shareholder Activism' (1990) 79 *Georgetown Law Journal* 445; Bernard Black, 'Shareholder Activism and Corporate Governance in the US' in Peter Newman (ed.), *The New Palgrave Dictionary of Economics and the Law Vol. 3* (Macmillan 1998) 459.
[3] See Section 4.4.5.

respect, they also help other mainstream investors to overcome collective action and free-rider problems.[4] With the emergence of hedge funds, mainstream investors have been transformed from 'rationally passive investors' to 'rationally reticent investors', that is, they are increasingly willing to engage in management, but they do not often initiate changes.[5] On the other hand, they are seen as short-term predators, which damage the long-term interests of companies, stakeholders, and the economy. Indeed, one of the drivers behind the development of the concept of stewardship was to resist pressures by activist funds. Hedge fund activism could have broader implications on company law and securities law,[6] beyond the concept of stewardship.[7] This study considers the role of hedge funds in corporate governance in the middle of these polar characterisations of hedge funds.

The call for regulatory reforms could be too narrow or too broad without understanding the different types of institutional shareholders and the dynamics of investment chains. This chapter starts with the growth of institutional shareholders in the US, and its implications for shareholder activism. The emergence of institutional share ownership in the UK took place almost three decades earlier than a similar development in the US. Therefore, the references to developments in the UK are made in this chapter. Then, it proceeds to examine the factors that form the business model of institutional investors. This analysis also shows why some shareholders adopt a hands-on approach, while others do not. Finally, it will discuss the features of different types of institutional shareholders.

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[4] Ronald Gilson and Jeffrey Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and The Revaluation of Governance Rights' (2013) 113 *Columbia Law Review* 863.
[5] See Gilson and Gordon (n 4).
[6] Marcel Kahan and Edward Rock, 'Hedge Funds in Corporate Governance and Corporate Control' (2007) 155 *University of Pennsylvania Law Review* 1021; Lucian Bebchuk, 'The Myth That Insulating Boards Serves Long-term Value' (2013) 113 *Columbia Law Review* 1637; Lucian Bebchuk, Alon Brav and Wei Jiang, 'The Long-Term Effects of Hedge Fund Activism' (2015) 115 *Columbia Law Review* 1085; Lynn Stout, *The Shareholder Value Myth* (Berrett-Koehler publisher, 2012); John Coffee, and Darius Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2016) 1 *Annals of Corporate Governance* 1; Leo Strine, 'Can We Do Better by Ordinary Investors; A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law' (2014) 114 *Columbia Law Review* 449.
[7] See for example, the Brokaw Act, S. 2720 — 114th Congress (2016).

4.2 The Growth of Institutional Shareholders

The core feature of corporate governance in the US and UK is the Berle-Means description of the dispersed share ownership of public companies. Shareholders are usually depicted as powerless and a group which is in need of legal protection,[8] but now we are in the age of 'investor capitalism'[9] or 'agency capitalism'.[10] This is related to the growth of institutional shareholders, i.e. the economic power of shareholders. Changes in the market challenge the assumption of the rational shareholder apathy discussed in Chapter 2.

The increase in institutional ownership and the corresponding ownership concentration in both jurisdictions remain different from other jurisdictions in which controlling shareholders are observed.[11] The change in the distribution of share ownership has led to the creation of a distinctive system of corporate ownership in which a number of institutions which hold shares on behalf of their beneficiaries own substantial blocks of shares in hundreds of corporations simultaneously.

The data collected by the UK's Office of National Statistics on the share ownership of listed UK equities[12] shows that institutional shareholders have increased their shareholdings dramatically at the expense of the direct holdings of individuals:[13] individuals have gone from 54.0% in 1963 to 11.9% in 2014, the rest of world from 7.0% to 53.8%, insurance companies from 10.0% to 5.9%, unit trusts from 1.3% to 9.0%, pension funds from 6.4% to 3.0% , and other financial institutions from 10.0% to 7.1%.

Share ownership in US public companies has been in transition from individual investors towards institutional shareholders over the past few decades. Institutional

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[8] See, Chapter 2.

[9] James Hawley and Andrew Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic* (University of Pennsylvania Press 2000).

[10] Gilson and Gordon (n 4).

[11] Gilson and Gordon (n 4) 876.

[12] Office of National Statistics (ONS), 'Ownership of UK Quoted Shares: 2014' (2 September 2015) https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2015-09-02 accessed 01 May 2017.

[13] Paul Davies, 'Shareholders in the UK' in Jennifer Hill and Randall Thomas (eds) *Research Handbooks on Shareholder Power* 357.

investors have started playing a greater role. [14] Although institutional investors are dominant players in that market, their holdings were much lower than their counterparts in the UK by the time the transformation started. Until the middle of the twentieth century, the majority of shares in US companies were held by individuals. For example, in the 1950s, institutional investors owned about 6% of the shares of public companies.[15] In the 1970s, their holdings reached about 18% and by 1990 they had increased to 37%.[16] By 2006, institutions held 70% of US equities[17] and in 2015 it was around 68%.[18] Institutional share ownership is very concentrated in the largest US companies.

In addition to the high institutional share ownership concentration in the top 1000 companies, the aggregate ownership of the top 25 institutional investors was around 30% of the shares of the top 10 largest US companies in 2009.[19] Clifford Holderness found that '[o]n average the large shareholders in a firm collectively own 39% (median 37%) of the voting power of the common stock' and 'ninety-six% of these firms have shareholders who own at least 5% of the firm's common stock ("blockholders")'.[20] Other research on ownership structures of public companies in the US indicates that block-holders are not as prevalent as Holderness suggests.[21] As a result, there is no completely dispersed ownership in which shareholders hold very few shares to control the performance of management. Rather, there is re-concentration of shares in the hands of institutional investors.

Individual shareholders owned more than 50% of the UK equity market in 1963, but this has steadily declined. By the mid-1970s institutional share ownership

[14] Marcel Kahan and Edward Rock, 'Embattled CEOs' (2009) 88 *Texas Law Review* 987.
[15] Lisa Fairfax, *Shareholder Democracy: A Primer on Shareholder Activism and Participation* (Carolina Academic Press 2011) 46.
[16] Fairfax (n 15), 46.
[17] Stuart Gillan and Laura Starks, 'The Evolution of Shareholder Activism in the United States' (2007) 19 *Journal of Applied Corporate Finance* 55.
[18] ProxyPulse, '2015 Proxy Season Wrap-up' (PwC 2015) < http://www.pwc.com/us/en/governance-insights-center/publications/assets/pwc-proxypulse-3rd-edition-august-2015.pdf >.
[19] Gilson and Gordon (n 4) 875.
[20] Clifford Holderness, 'The Myth of Diffuse Ownership in the United States' (2009) 22 *Review of Financial Studies* 1377, 1378-82
[21] Brian Cheffins and Steven Bank, 'Is Berle and Means Really a Myth?' (2009) 83 *Business History Review* 443, 446.

exceeded individual ownership, something that was also observed in the US at the end of the century.[22] From a comparative company law perspective, the early rise of institutional shareholders in the UK enabled them to influence the management of their investee companies and to shape corporate governance in favour of shareholders in the UK. Institutional investors are relatively more interested in the second role[23] and played an important part in the development of such an engagement culture by systematically influencing the formation of legal rules and norms which allowed them to engage in low-cost activism in the event of poor management performance.[24]

In light of these changes in the share structure of US and UK companies, it is fair to conclude that the share ownership of listed companies is not fully dispersed as described by Berle and Means. The transformation of share ownership created a different type of separation of ownership and control in which institutional shareholders control the investments of the ultimate beneficiaries.

The re-concentration of shares in the hands of institutional investors could overcome the problems of collective action and free-riding.[25] It obviously increases the proportional benefit of institutional shareholders. It is also argued that shareholder engagement can create positive externalities by constituting a signal to the management of other investee companies and thus can play a disciplinary function that improves portfolio value.[26] Moreover, the exit option becomes more expensive because 'institutional shareholders, who increasingly own large unmarketable blocks, must accept substantial price discounts in order to liquidate these blocks'.[27] Therefore, in the context of a reverse relationship between exit and voice, the growth of

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[22] Fairfax (n 15) 46; see also John Armour and David Skeel, 'Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation' (2007) 95 *The Georgetown Law Journal* 1727, 1767-8.
[23] See Davies (n 13).
[24] John Armour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment' in Alessio Paccess (eds) *The Law and Economics of Corporate Governance* (Edward Elgar 2010) 213, 215.
[25] Alfred Conard, 'Beyond Managerialism: Investor Capitalism' (1988) 22 *University of Michigan Journal of Law Reform* 117.
[26] Iain Macneil, 'Activism and Collaboration among Shareholders in UK Listed Companies' (2010) 5(4) *Capital Markets Law Journal* 419 at 429.
[27] See John Coffee, 'Liquidity Versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 *Columbia Law Review* 1277, 1288-9.

institutional shareholdings increases the possibility of voice while reducing the scope of exit. In such situations, engagement becomes a less costly option than exit.[28] Another impact of the re-concentration of shares on the economic analysis is that institutional shareholders can reach sufficient economic power to establish coalitions or trade organisations that could put pressure on companies to comply with good governance principles.[29] In sum, the growth of institutional share ownership makes shareholder activism more likely.

Institutional shareholders do not engage in the same type and quality of shareholder activism due to cost of activism and the business model of institutional shareholders. For instance, attending general meetings and responding shareholder proposals may not constitute a significant economic burden for shareholders. In the US, the voting participation of institutional shareholders was around 91% in 2016.[30] The core problem in the US was that shareholders tended to overwhelmingly use voting rights in favour of the management proposals and against shareholder proposals.[31] Now, the behaviour of traditional investors is changing and they tend to support shareholder proposals on independent directors, removal of takeover defences, and executive remuneration[32], and oppose management proposals.[33] However, the cost of a proxy contest against management could still be a deterrent even for institutional shareholders. For instance, any activism ending in a proxy fight may cost as much as

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[28] This forces fund managers to communicate with the investee company to change company strategy. See John Hendry and others, 'Responsible Ownership, Shareholder Value and the New Shareholder Activism' (2007) 11 *Competition and Change* 223, 232.

[29] See, Geof Stapledon, *Institutional Shareholders and Corporate Governance* (Clarendon Press 1996), 79.

[30] Proxy Pulse, '2016 Proxy Season Review' (ProxyPulse 2016) <http://media.broadridge.com/documents/Broadridge-ProxyPulse-3rd-Edition-2016.pdf> accessed 27 October 2016; see also,Chris Mallin, 'The Voting Framework: A Comparative Study of Voting Behaviour of Institutional Investors in the US and the UK' (1996) 4(2) *Corporate Governance* 107, 115.

[31] Randall Thomas and James Cotter, 'Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction' (2007) 13 *Journal of Corporate Finance* 368; Gerald Davis and Han Kim, 'Business Ties and Proxy Voting by Mutual Funds' (2007) 85 *Journal of Financial Economics* 552; Gerald Davis, 'A New Finance Capitalism? Mutual Funds and Ownership Re-Concentration in the United States' (2008) 5 *European Management Review* 11, 20.

[32] Ian Appel, Todd Gormley and Donald Keim, 'Passive Investors, Not Passive Owners' (2016) 121 *Journal of Financial Economics* 111.

[33] Gilson and Gordon (n 4) 887.

$10 million.[34] In the case of proxy fights, the deterrent effect of the high cost of activism could be true, but not necessarily so in the case of simply casting votes on a proposal.[35] Some institutional shareholders are able to exercise even costly shareholder activism because of their business model. Share ownership of institutional shareholders is not only the determinant of shareholder activism. The features of institutional shareholders also play a role in shareholder activism.

4.3 Institutional Shareholders and Investment Managers

Institutional shareholders are not a homogenous group.[36] There are a number of factors that make up their business models. Hence, the term 'institutional investor' is too nebulous a term to capture the quality and degree of activism and for making the case for regulatory and legal reforms. Before discussing these factors, a distinction between asset managers, or fund management companies, and asset holders is needed in order to understand how institutional shareholders interact with the management of a company and how the investment chain works in practice. It would be normal to assume that institutional investors carry out the monitoring and governance role in corporate governance, but they often delegate the management of the fund to fund management companies. In other words, there are two dimensions of institutionalisation: institutional investment and asset or fund management.[37]

4.3.1 Investment Managers

Fund management is a part of the institutional investment process, but the asset managers may not be a part of the institutional investors in the legal sense.[38] Fund managers can be independent fund management firms, internal parts of large funds, life insurers or independently capitalised firms owned by insurance companies. Therefore, the distinction between institutional investors and asset managers is not

[34] Nickolay Gantchev, 'The Costs of Shareholder Activism: Evidence from a Sequential Decision Model' (2013) 107 *Journal of Financial Economics* 610, 611.
[35] See Investment Company Institute., *A Guide to Understanding Mutual Funds* (2007).
[36] See Celik and Isaksson (n 1).
[37] Philip Davis and Benn Steil, *Institutional Investors* (The MIT Press 2001), XXIV.
[38] Davis and Steil (n 37) 114.

clear cut and the terms 'institutional investor' or 'institutional shareholders' may embrace both institutional investors and fund management firms.

The assets of US-registered investment companies reached $19 trillion in 2016.[39] Another study found that the assets controlled by US asset managers is around €33 trillion.[40] Similarly, the Office of Financial Research (OFR) found that the US asset management industry controlled $53 trillion in 2013.[41] In the UK, the FRC found that the UK asset management industry reached £6.6 trillion in 2016.[42] Not all the amount of money under management of a company is, of course, invested in stock markets.[43] The asset managers market is highly competitive and concentrated. The assets under management of the top 10 US management firms accounted for approximately 34% of the total assets in 2012.[44] A similar pattern is also observed in the UK. In the UK, the 10 largest firms controlled approximately 50% of the total assets managed by British asset managers in 2013.[45] Pension funds and mutual funds are by far the largest clients of asset managers.

Two conclusions can be drawn from the structure of the investment chain and the concentration of the investment management industry. As the sector is highly concentrated in the hands of a few fund managers, forming a coalition and overcoming collective action problems may be easier. However, and the situation also creates an accountability gap in the investment chain because it increases the length of that chain

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[39] Investment Company Institute, 'Investment Company Fact Book 2017' < https://www.ici.org/pdf/2017_factbook.pdf > accessed 8 June 2017.

[40] Liam Kennedy, 'Top 400 Asset Managers 2015: Global assets top €50trn' *Investments and Pensions Europe* (June 2015) < https://www.ipe.com/reports/top-400-assetmanagers/top-400-asset-managers-2015-global-assets-top-50trn/10008262.fullarticle > accessed 10 May 2017.

[41] The US Office of Financial Research (OFR), *Asset Management and Financial Stability* (September 2013) <http://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf>; TheCityUK, *UK Fund Management 2014: an Attractive Proposition for International Funds* (September 2014) < http://www.thecityuk.com/research/our-work/reports-list/uk-fund-management-2014/> accessed 17 July 2015.

[42] FCA, 'Assets under Management' (2016) https://www.fca.org.uk/your-fca/documents/infographic-assets-under-management accessed 19 March 2017.

[43] Investment Management Association (IMA), *Asset Management in 2013-2014: The IMA Annual Survey* 98 <http://www.theinvestmentassociation.org/assets/files/research/2014/20140909-IMA2013-2014-AMS.pdf> accessed 17 July 2015.

[44] OFR (n 41) 5.

[45] IMA (n 43), 96-8.

and exacerbates the disincentives to a higher level of engagement arising from asset managers' own business model, as will be seen below.

4.3.2 Institutional Shareholders

Institutional shareholders have different characteristic features due to their different business models of institutional investors. It is impossible to give an exhaustive list of these factors. The relevant major factors will be covered here briefly.

The first factor is the liability structure of institutional shareholders. It determines whether they can adopt a long-term or a short-term investment strategy. The second is the fee structures of institutional investors and investment managers. It is of major importance for shareholder activism because the different fee structures of asset managers might encourage different behaviours. There are mainly two types of fees: management fee and performance fee.[46] Management fees are generally either a fixed proportion of the assets controlled or a fixed amount. These types of fees reward the manager for asset growth and punish them for asset shrinkage. Performance fees are a fixed percentage of the return delivered to the client. While traditional investors usually apply the management fees, activist funds apply the combination of management fees and performance fees. For hedge funds, it becomes more rational to develop firm-specific strategies and to engage in the monitoring of management. The impact of fee structures should be considered in the context of how the success of investment managers is measured.

In particular, pension funds and mutual funds aim to deliver competitively superior performance at the lowest possible cost.[47] Competition forces institutions to measure success based on relative performance. In this regard, it does not encourage shareholder activism even if it would be beneficial for the ultimate investors. The asset manager, who engages with management, incurs all the costs of activism, and if activism becomes successful, all the gains will be shared by other institutional shareholders. More importantly, it will increase the overall success of other fund

[46] CFA, 'Fees and Compensation' (April 2013) < https://www.cfauk.org/-/media/files/pdf/pdf/5.../3.../fees-and-compensation.pdf> accessed 09 May 2017.
[47] Gilson and Gordon (n 4) 890.

managers. It therefore provides very little competitive advantage to asset managers that engage in activism compared to those that do not. Likewise, Rock states that 'a change that benefits all will benefit none'.[48]

Furthermore, the distribution of the cost of shareholder activism between the external fund manager and an institutional shareholder is an important factor for the external fund managers. The cost of activism is not usually shared between the external fund manager and institutional shareholders even if the activism will benefit the institutional shareholders and their ultimate beneficiaries.[49] Black and Coffee argued that if an external 'pension fund manager does not seek reimbursement from its clients for expenses, then the expected benefit must be huge to justify the manager incurring any expense.'[50] Black and Coffee gave the example that an external fund manager controls 1% of a company capitalised £1,000 million; that the proposed changes would increase the value of investee company by 10 %, which would deliver £1 million gain to the fund manager's client, and that the cost of joining a shareholder coalition for shareholder activism is £30,000.[51] It would make sense for an institutional shareholder to join such coalition, given the expected benefit from activism. However, because of the way in which the fund managers charge their clients, the fund manager would receive only £4,960.[52] So even when shareholder activism is economically rational for the ultimate beneficiaries, it may not be rational for the fund managers because of the combination of the fee structure and fund manager performance measurement. As noted above, the use of investment managers could have negative impact on shareholder activism. The external fund manager, therefore, mostly focusses on the formation of a portfolio, which best fits in its expectations.[53] In-house

[48] Rock (n 2), 473-4.
[49] Stapledon (n 29) 261-2.
[50] Bernard Black and John Coffee, 'Hail Britannia?: Institutional Investor Behavior under Limited Regulation' (1994) 92(7) *Michigan Law Review* 1997, 2057.
[51] Black and Coffee (n 50) 2057-8.
[52] Black and Coffee (n 50) 2057-8.
[53] Anna Tilba and Terry McNulty, 'Engaged versus Disengaged Ownership: The Case of Pension Funds in the UK' (2013) 21(2) *Corporate Governance: An International Review* 165, 166.

fund managers are not exposed to relative performance measurements as much as external fund managers. Therefore, they are more likely to engage in activism.[54]

Investment strategy is another important part of the institution's business model. In principle, there are as many investment strategies as there are investors. The investment strategies also have an impact on management behaviour by shaping the outcomes of voting in companies. Nevertheless, three groups of institutional investors can be identified based on their investment strategies. The first group are transient investors who have small stakes and high turnover, employ momentum trading strategies (i.e. trade according to earning news).[55] The second group are the dedicated investors who focus on specific companies, own relatively large stakes in a select set of companies for the long-term and trade relatively infrequently.[56] The third group are quasi-indexers who also trade infrequently but hold small stakes in a large number of companies (akin to index funds).[57] The quasi-indexers are traditionally perceived as passive owners having no interest in the decision-making of companies. However, the emerging literature suggests that quasi-indexers tend to become involved in a number of corporate governance issues such as independence of the board members, anti-takeover mechanisms, and tax planning.[58] They exert influence by virtue of their voting power and increasingly take an active role in shaping corporate governance and become 'rationally reticent'.[59]

To sum up, these determinants make up the business models of the institutional investors. The business model of the institution determines the quality and type of shareholder engagement. Therefore, institutional investors are not a homogenous

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[54] Stapledon notes that 'of the four UK fund managers interviewed by the author who were engaged full-time (or most full time) on matters of corporate governance and problem companies, two were senior executives of fund-management arms of large insurers, and one was a senior officer of an in-house pension fund manager.' See Stapledon (n 29), 260.

[55] Brian Bushee, 'Identifying and Attracting the "Right" Investors: Evidence on the Behaviour of Institutional Investors' (2004) 16(4) *Journal of Applied Corporate Finance* 28, 29.

[56] Bushee (n 55) 29.

[57] Bushee (n 55) 29.

[58] Ian Appel et al., 'Passive Investors, not Passive Owners' (2016) *Journal of Financial Economics* 1 (article in press); Audra Boone and Joshua White, 'The Effect of Institutional Ownership on Firm Transparency and Information Production' (2015) 117 *Journal of Financial Economics* 508; Shuping Chen et al., 'Quasi-Indexer Ownership and Corporate Tax-Planning' (2015) SSRN Electronic Journal <http://papers.ssrn.com/abstract=2610826> accessed 15 April 2016.

[59] See Gilson and Gordon (n 4).

group and determining factors vary not only between different types of institutional investors, but also within the same category of institutional investor.

4.3.2.1 Pension Funds

A pension fund is a fund which is established to facilitate and generate employees' retirement income and is contributed to by both the employer and employee. They are usually formed as a separate entity from the employing entity which enables employees to accumulate savings throughout their working life in order to receive income in retirement. Thus, they are often regarded as vehicles which can adopt a long-term investment strategy on share ownership and management,[60] but the way in which pension funds are managed is equally important.

Pension funds are usually organised on a trust basis as a separate entity from their sponsors[61] and are obliged to act according to trust law principles.[62] Trustees are under a duty to exercise their power and to hold assets in the best interests of their members and beneficiaries.[63] Pension schemes can be further divided into two groups according to the distribution of risk between the member and sponsor: defined benefit and defined contribution.[64] In the former, the sponsor undertakes to contribute a percentage of the final or average salary.[65] Employers carry the risk of paying benefits should the fund prove inadequate. In the latter, where the contribution is fixed, each member's income depends upon market returns so the risk is on the employees[66] who have no entitlement to a fixed income in retirement. In the US, a shift from defined benefit pensions to defined contribution pensions took place in the 1990s.[67] As a result of this shift, employees are in a position to make investment options given by the pension plan; their pension wealth mostly depends on the market and is less dependent

[60] Tilba and Terry (n 53), 166.
[61] Paul Myners, Institutional Investment in the United Kingdom: A Review (London 2001), 4-5.
[62] Judith Donnelly, 'Occupational Pension Schemes' in Timithy Spangler (ed.) *Investment Management Law and Practice* (OUP 2010), 1049.
[63] Section 403(c) of ERISA; Regulation 4 of the Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations).
[64] Philip Davis *Pension Funds: Retirement-Income Security and Capital Markets* (Clarendon Press, 1995), 5.
[65] Davis (n 64), 6.
[66] Davis (n 64), 6.
[67] Gilson and Gordon (n 4) 883.

on the employer. They are increasingly choosing mutual funds for their investment management.[68] In turn, the features of these plans determine the incentives of mutual funds to intervene in the management of portfolio companies.

Some corporate pension plans (schemes) are subject to conflicts of interest. Pension funds can face pressure from corporate management to support the management.[69] An important difference exists between UK and US pension funds. As British funds are more likely to invest through 'in-house managers,' they are subject to fewer conflicts of interest than their US counterparts.[70] In the US, these conflicts of interest affect the voting policy of institutional investors because the management of companies choose the trustees who are responsible for the plan and the trustee picks an investment fund manager to manage the capital.[71] They are therefore less likely to introduce shareholder proposals against management.[72]

Pension funds are also subject to a diversification requirement in order to avoid the risk of large losses although a specific percentage is not specified in the regulations.[73] This makes it easier for them to prefer an index or quasi-index investment strategy. They are therefore mostly interested in governance issues rather than developing a firm-specific approach unless they have significant economic power.

Pension funds manage their investments in a number of different ways. Some pension funds, particularly large ones, are internally managed, whereas the majority of pension funds rely on a chain of external financial intermediaries including consultants, actuaries, and fund managers; thus they manage their relationship with investee companies at a significant distance.[74] Since the performance measurement of external fund managers are done according to relative performance, fund managers

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[68] Gilson and Gordon (n 4) 882.
[69] Bernard Black, 'Shareholder Passivity Re-examined' (1990) 89(3) *Michigan Law Review* 520, 597.
[70] Coffee (n 27), 1310.
[71] Paul Edelman et al, 'Shareholder Voting in an Age of Intermediary Capitalism' (2014) 87 *Southern California Law Review* 1359, 1401.
[72] The Manhattan Inst. Ctr. for Legal Policy, A Report on Shareholder Activism 2015, (ProxyMonitor 2015) < http://www.proxymonitor.org/pdf/pmr_11.pdf>, 2.
[73] Reg. 4(7) of the Occupational Pension Schemes (Investment) Regulations 2005 SI 2005 No 3378; Sec 404 of ERISA.
[74] Tilba and McNulty (n 53) 166.

will have less incentive to engage in firm-specific activism, but tend to engage in governance activism and to vote on shareholder proposals submitted by management or activist funds. In-house fund managers will be less likely to be subject to this disincentive because they are not under pressure to attract more clients at the lowest fees, unlike external fund managers.

Recent research into UK pension funds' behaviour vis-à-vis portfolio companies revealed that large pension funds with in-house investment management tend to take a more activist stance in their portfolio companies.[75] Large pension funds are able to and often exhibit a number of engaged ownership behaviours 'namely, conducting company research and monitoring, voting and proxy voting, writing letters, and holding face-to-face meetings with senior management and boards of directors about structural and strategic corporate governance issues.'[76] Some of them consider that it is also part of their duties to influence the companies.[77] Internally employed full-time people are of great importance to the hands-on approach, but it requires resources which some pension funds do not have for governance engagement.

This analysis shows that the funds' proximity to the investee company and the internal management teams play a role in shareholder behaviour and enable them to adopt a 'hands-on' approach, but this depends heavily on the size of the pension fund and whether they are willing to devote resources to internal departments for shareholder engagement.

Research has found that not only capacity but also willingness and understanding of duties with regard to trust play crucial roles in the form of shareholder engagement.[78] Therefore, the pressure from policy-makers or the market initiatives discussed in Chapter 3 could force institutional shareholders to internalise shareholder activism into their investment policies. The result is that there is a strong correlation between the size of a pension fund, the size of internal specialised

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[75] Tilba and McNulty (n 53) 171.
[76] A similar observation is made for the US pension funds. See also, Stephen Choi and Jill Fisch, 'On Beyond Calpers: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance' (2008) 61 *Vanderbilt Law Review* 315, 317.
[77] Tilba and McNulty (n 53) 172.
[78] Tilba and McNulty (n 53) 172.

departments and their willingness to engage in activism. In these funds, the culture of shareholder engagement is internalised through trustees and other internal departments and not regarded as a requirement to be fulfilled.

The majority of the rest of pension funds, however, rely heavily on external consultants and investment fund managers in strategic decision making. They usually do not have dedicated staff for this activity. The overreliance on external consultants such as actuaries, investment consultants and fund managers also introduce inherent limitations. The lack of internal specialised departments accounts for why some institutional shareholders are responsive to proposals but avoid taking a proactive stance in corporate governance.[79]

Public pension funds could pursue ESG issues or the managers of these funds could target political interests.[80] Public pension funds in the US are subject to fewer regulations and conflicts of interest compared to mutual funds. For example, they can apply performance-based fees.[81] They often invest in hedge and venture funds in order to avoid potential criticisms.[82] In general, they are not subject to competition for investment capital, and accordingly they have little financial incentive to take an active stance in corporate governance, but they are subject to pressure by politicians, officials and unions.[83] They could potentially support the board and management against controversial objectives of activist funds. Moreover, they can support shareholder proposals on governance issues such as excessive pay for executives.[84]

In conclusion, pension funds are long-term investors. Large pension funds are internally managed and have sufficient resources to exercise defensive shareholder activism and to establish strong engagement with the board. They can play a stewardship role in corporate governance. Relatively smaller funds delegate fund management to external managers. It is less likely that these smaller funds will take a

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[79] Tilba and McNulty (n 53) 174; Fairfax (n 15) 51.
[80] See generally, Roberta Romano, 'Public Pension Fund Activism in Corporate Governance Reconsidered' (1993) 93 *Columbia Law Review* 795.
[81] Marcel Kahan and Edward Rock, 'Hedge Funds in Corporate Governance and Corporate Control' (2007) 155 *University of Pennsylvania Law Review* 1021, 1058.
[82] Kahan and Rock (n 81) 1059.
[83] Kahan and Rock (n 81) 1059.
[84] Kahan and Rock (n 81) 1062.

hands-on approach in corporate governance. However, they are mostly responsive to shareholder and management proposals. In other words, they could exercise informed voting and could potentially carry out stewardship responsibilities. Therefore, defensive and responsible activism are a better fit with most pension funds' business models.

4.3.2.2 Mutual Funds

Mutual funds are one of the main investment vehicles for US investors. They are pools of assets such as shares, bonds and other types of securities. The shift from defined benefit to defined contribution pension plans has channelled new capital from self-employed individuals to mutual funds.[85] Currently, pension plans constitute at least half of mutual funds.[86] In addition to retirement plans, individuals and other institutional investors invest in mutual funds.

They are, therefore, economically powerful. A total of $18 trillion worth of assets was controlled by mutual funds in 2016.[87] Approximately 90 million individual investors owned mutual fund shares, either directly or through retirement plans.[88] Mutual funds are estimated to own almost 25% of the outstanding shares of US public companies in 2016.[89] Although there are many mutual firms, their power is concentrated in the hands of the 25 largest that manage approximately 74% of the total share of mutual markets.[90] This enables them to play a significant role in the governance of large public companies and to affect voting results on matters from corporate governance to executive compensation or social policy.

The market is very competitive because mutual funds compete with each other to be chosen as one of the retirement plan options by an employer. In order to survive in this competitive environment, they aim to provide a diversified portfolio at low cost.

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[85] Jennifer Taub, 'Able but Not Willing: The Failure of Mutual Fund Advisors to Advocate for Shareholders' Rights' (2009) 34(3) *The Journal of Corporation Law* 843, 849.
[86] Edelman et al (n 71) 1390.
[87] Investment Company Institution (ICI), '2016 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry' (2016) <https://www.ici.org/pdf/2016_factbook.pdf> accessed 06 May 2017.
[88] ICI (n 87),14.
[89] ICI (n 87), 14.
[90] ICI (n 87), 17.

In addition to this market incentive, the regulations encourage mutual funds to diversify their investments.[91] As a result, mutual funds tend to hold small percentages of shares in many companies because of the logic of diversification.

Their relative performance is competitively important in attracting new clients and the ultimate beneficiaries. Initiating costly forms of activism may therefore not benefit the manager of the funds even if it would be beneficial for the ultimate beneficiaries. Put differently, their fee structure and performance measurement discourage them from developing firm-specific solutions for agency problems in the portfolio companies.

Market pressure often incentivises mutual funds to favour rather than to challenge management because of their business relationship or their financial interest to manage company's employee benefit plans.[92] As noted above, this is one of the major problems in the US investment industry. However, this trend has been gradually changing and mutual funds are becoming more responsive and more sceptical of management with the help of increased transparency and clarification of fiduciary duties. Rothberg and Lilien concluded that 'the funds often voted against managements' recommendations on issues of executive compensation, on board's independence and on possible takeovers.'[93] Likewise, mutual funds have been increasingly engaging in activism in relation to governance matters and the increased holding of funds is found to play a role in board independence, the removal of anti-takeover mechanisms, the increasing use of equal voting rights and more transparency and less information asymmetry.[94] The Investment Company Institute also found that favouritism towards management has been in decline.[95] In line with these developments, it is reasonable to conclude that a shareholder engagement culture is

[91] Section 5(b)(1) of the 1940 Act.
[92] Davis and Kim (n 31).
[93] Burton Rothberg and Steven Lilien, 'Mutual Funds and Proxy Voting: New Evidence on Corporate Governance', (2006) 1 *Journal of Business & Technology Law* 157, 171.
[94] Kahan and Rock (n 14) 1001-4; Appel et al (n 58); Audra Boone and Joshua White 'The effect of institutional ownership on firm transparency and information production' (2015) 117 *Journal of Financial Economics* 507.
[95] ICI, 'Trends In Proxy Voting By Registered Investment Companies 2007–2009', (2010), 12 fig. 8.

developing in the mutual fund sectors. For example, the Chairman and CEO of Vanguard Funds stated that:

> 'Our favourite holding period is forever. We're going to hold your stock when you hit your quarterly earnings target. And we'll hold it when you don't. We're going to hold your stock if we like you. And if we don't. We're going to hold your stock when everyone else is piling in. And when everyone else is running for the exits … That is precisely why we care so much about good governance.'[96]

The emerging paradigm and the US Stewardship Principles discussed in Chapter 3 show mutual funds as willing to support management in adopting long-term corporate strategies. The recent literature supports the argument that mutual funds are in fact 'passive investors not passive owners' and are challenging the management.[97] In other words, while mutual funds do not still actively trade shares and are long-term investors, they are now willing to engage with the management of the portfolio companies. The distinction between passive investment strategy and passive ownership is becoming more evident. Adopting a passive investment strategy does not preclude funds from developing long-term constructive dialogue with the management of companies.[98] Kahan and Rock described this situation as 'the awakening of mutual funds.'[99] This shows that while mutual funds adopt passive index or quasi-index investment strategies, they are nonetheless responsive to proposals and could exercise informed voting.

As a result, in particular, large mutual funds could exercise defensive and responsible activism, like pension funds. As discussed in Chapter 3, they develop an investor paradigm that aims to foster constructive shareholder engagement. They can play a stewardship role in enhancing long-term investments. However, this does not

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[96] William McNabb, 'Getting to Know You: The Case for Significant Shareholder Engagement' (Harvard Law School Forum on Corporate Governance and Financial Regulation (HLSFCGF), 24 June 2015) < https://corpgov.law.harvard.edu/2015/06/24/getting-to-know-you-the-case-for-significant-shareholder-engagement/>.
[97] Appel et al (n 58).
[98] Mike Scott, 'Passive Investment, Active Ownership' *Financial Times* (6 April 2014); see also Glenn Boorem, 'Passive Investors, not Passive Owners' (Vanguard, 16 May 2014) < https://personal.vanguard.com/us/insights/article/proxy-commentary-042013>.
[99] Kahan and Rock (n 94) 1001.

mean unconditional support for the board and management. They are also increasingly interested in governance issues, so they play a role in shaping corporate governance.

4.3.2.3 Insurance Companies

Insurers are important suppliers of long-term savings like pension funds and have long been important institutional investors that facilitate sustainable economic growth.[100] The activities of insurance companies fall into two groups, long-term and general. General activities include fire, accident, motor and marine insurance. Long-term activities are mostly related with life assurance, permanent health insurance and capital redemption. Life insurance policies may be linked with investments and may entitle policyholders to demand a share of the profits. For the purposes of this thesis, the focus will be on life insurance companies.

Insurance companies are under a duty to manage their investments on behalf of policy holders with due diligence. In this regard, defensive shareholder activism, i.e. the protection and enhancement of investments, is therefore beneficial. Three factors generally determine the insurer's investment strategy: 'the profile of liabilities … the asset universe and associated risk-return profiles [and] the framework conditions created by regulatory decisions'.[101] They usually establish a special fund management arm which provides management services not only to the insurance company but also other institutional investors.

In the US, life insurance companies owned $6.3 trillion in real and financial assets in 2015.[102] They invest in a wide variety of assets ranging from real estate to derivative assets. In general, equities constituted only 2.3 % of the total invested assets of insurance companies in 2013.[103] They also directly invest in hedge funds and other

[100] HM Treasuary, *The UK Insurance Growth Action Plan* (2013) < https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263148/the_UK_insurance_growth_action_plan.pdf> at 15 accessed 18 April 2015.
[101] Oliver Wyman, 'Funding the Future: Insurers' role as institutional investors' (Insurance Europe, 2013) 10-13, < http://www.insuranceeurope.eu/uploads/Modules/Publications/funding-the-future.pdf> accessed 16 April 2015.
[102] Milliman, 'Investment Strategies of US life insurers in a low interest rate environment' (May 2016) *Milliman Research Report* < http://us.milliman.com/uploadedFiles/insight/2016/us-life-insurance-strategies-low-interest-environment.pdf > accessed 09 May 2017.
[103] Robert McMenamin, 'What Do US Life Insurers Invest in?' (2013) 309 *Chicago Fed Letter* 1.

private equity firms.[104] Insurance companies in the US are reluctant to take an active stance in corporate governance because of the fact that in the past insurance companies were prohibited from investing in shares.[105] In contrast to the US insurance companies, historically UK insurance companies have played a significant role in the management of portfolio companies and in shaping corporate governance. They played a key part in the establishment of shareholder coalitions and removals of directors, and exert voting rights more often than other institutional investors.[106] Stapledon found that a significant number of fund management arms of insurers voted very frequently and had regular meetings with the management of portfolio companies.[107] The influence of UK insurance companies is not surprising because they are not subject to economic disincentives linked to performance measurements as much as external fund managers of other institutional investors. The largest insurance firms conduct active monitoring independent of any governance or operational crisis by arranging regular reviews and meetings with investee companies.[108] The reason why the large insurance companies engage in direct monitoring of portfolio companies is that since they manage shares for themselves and on behalf of other investors, they readily conclude that engagement and other relevant costs are in the interests of all the beneficiaries and spread the costs among other investors receiving the benefit.[109]

To sum up, insurance companies are long-term investors and have the capacity to exercise both defensive and responsible activism.

[104] Milliman (n 102).
[105] Mark Roe, 'Foundations of Corporate Finance: The 1906 Pacification of the Insurance Industry' (1993) 93(3) *Columbia Law Review* 639, 640, 679-81.
[106] Rafel Crespi and Luc Renneboog 'Is (Institutional) Shareholder Activism New? Evidence from UK Shareholder Coalitions in the Pre-Cadbury Era' (2010) 18(4) *Corporate Governance: An International Review* 274, 292.
[107] Stapledon (n 29), 95.
[108] Bernard Black and John Coffee, 'Hail Britainia? Institutional Investor Behavior under Limited Regulation' (1994) 92 Michigan Law Review 1997, 2047.
[109] Black and Coffee (n 108), 2081.

4.3.2.4 Sovereign Wealth Funds

Sovereign Wealth Funds (SWFs) have been around for almost six decades.[110] They first appeared in the 1950s[111] and over half a century, SWFs have become important entities in corporate governance and global markets.[112] Total assets under management of SWFs increased from less than $1 trillion in 2000 to $6 trillion by 2012.[113]

SWFs have a unique feature: they are owned and controlled by a foreign government and are 'set up to serve the objectives of a stabilisation fund … by investing the funds on a long-term basis, often overseas'.[114] Each SWF has a different objective which need not be disclosed as these entities are under the control of sovereign governments.[115] In essence, they are creations of a state, but at the same time they are also private market participants. This dual nature of SWFs has triggered debates about hidden agendas in both the public and academic world.[116]

SWFs are a heterogeneous group and can differ on the basis of their stated policy objectives and asset allocation. SWFs, and in particular savings and pension SWFs, are able to adopt an investment strategy for the long-term with a multi-year horizon, and to take risks.[117] Those funds can also increase the long-term investor base for risky assets such as stocks and corporate bonds. In this way, they can play an important role in financial stability. For example, SWFs experienced large losses during the financial crisis in 2008 because of the sharp decline in stock exchange markets, but they recovered their losses in the following years by being long-term

[110] Simon Johnson, 'The Rise of Sovereign Wealth Funds' (2007) 44(3) *Finance and Development* 1, 1.

[111] Bruce Bean, 'Attack of the Sovereign Wealth Funds: Defending the Republic from the Threat of Sovereign Wealth Funds?' (2009) 18(1) *Michigan State Journal of International Law* 66, 72.

[112] Harry Markowitz, 'Foundations of Portfolio Theory' (1991) 46 *Journal of Finance* 469.

[113] Gordon Clark, Adam Dixon and Ashby HB Monk, *Sovereign Wealth Funds: Legitimacy, Governance, and Global Power* (Princeton University Press 2013).

[114] Steven Kern, 'SWFs and Foreign Investment Policies: An Update', *Deutsche Bank Res* (22 October 2008), 2

[115] Bean (n 111), 73.

[116] Bean (n 111), 74-5.

[117] Ludwig Gramlich, 'An International Normative Framework for Sovereign Wealth Funds?' in Christoph Herrmann and Philipp Terhechte (eds) *European Yearbook of International Economic Law 2011* (Springer 2011), 48.

investors.[118] Despite being long-term investors, they are often reluctant to influence company policies by using their voting rights.[119] This passivity is often a deliberate choice in order to avoid a political backlash, and they generally try to ensure that their strategies are based on commercial grounds. They therefore organise their investments so that they do not have a controlling interest in the investee company.[120] One of the preferred ways to avoid scrutiny is to buy non-voting shares.

That said, there is an emerging trend of SWFs adopting a more activist approach.[121] They have the potential to engage with companies through 'proactive' and 'reactive' governance.[122] For example, Norges Bank Investment Management (NBIM) adopts a 'proactive' kind of engagement that includes board nominations, proposals on corporate governance, environmental and social matters and advising business strategy.[123] The bank applies principles of responsible investment.[124] Another example is Qatar Holdings which took a reactive stance in the Glencore Xstrata merger. Qatar Holdings acted as a roadblock by increasing its shareholdings in Xstrate and insisted on higher compensation. Following this action, Glencore had to increase its offer before the transaction was approved. Qatar Holdings did not actively engage in ongoing governance matters but used its power as an activist.[125]

To sum up, sovereign wealth funds are able to adopt a long-term investment horizon and can integrate ESG issues into investment strategies. Even though they are traditionally passive shareholders, there are some funds which adopt defensive and

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[118] Abdullah Al-Hassan et al, 'Sovereign Wealth Funds: Aspects of Governance Structures and Investment Management' (2013) *IMF Working Paper 13/231* at 1.

[119] Dale Gabbert, 'Sovereign Wealth Funds' in Spangler (62) at 1178; see also Yaron Nili, 'The Corporate Governance of Sovereign Wealth' (HLSFCGF, 7 August 2014) <http://corpgov.law.harvard.edu/2014/08/07/the-corporate-governance-of-sovereign-wealth-funds/> accessed 25 April 2015.

[120] Paul Rose, 'Sovereign Wealth Funds, Active or Passive Investors?' (2008) 118 *Yale Law Journal Pocket Part* 104, 105.

[121] Joel Slawotsky, 'Incipient Activism of Sovereign Wealth Funds and the Need to Update United States Securities Laws' (2015) 2015 *International Review of Law* 8..

[122] Joel Slawotsky, 'Sovereign Wealth Funds as Emerging Financial Superpowers: How U.S. Regulators Should Respond' (2008) 40 *Georgetown Journal of International Law* 1239, 1255.

[123] Nili (n 119).

[124] Larry Backer, 'The Norwegian Sovereign Wealth Fund: Between Private and Public' (2008) 40 *Georgetown Journal of International Law* 1271.

[125] Slawotsky (n 121), 19.

responsible activism. Therefore, some sovereign wealth funds could play a stewardship role in corporate governance.

4.3.2.5 Hedge Funds

Hedge funds have grown exponentially, and controlled globally approximately $2.8 and $3.22 trillion of assets in 2014 and 2016 respectively.[126] Although not all hedge funds are non-activist, the ones that are have drawn attention in recent years.[127] Activist funds, led by a number of hedge funds, have begun carrying out an active role which has led a surge in shareholder activism.[128] The increasing hedge fund activism has stimulated other institutional shareholders which are willing to take an active role in corporate governance, and has led to an overall increase in activism by mainstream shareholders.[129] Icahn, one of the most prominent and long-term investors who purchases large stakes and seeks changes in corporate strategies, described this era as one in which 'there has never been a better time than today for activist investing, if practised properly'.[130]

Activist hedge funds have been subjected to much criticism over whether they use their expertise to protect shareholder interests, or to extract private benefits at the expense of other shareholders and the long-term health of the economy.[131] They have provoked fierce debate, not only in academia, but throughout society.[132]

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[126] Credit Suisse, 'The 2014 Credit Suisse Global Survey of Hedge Fund Investor Appetite and Activity' (2014) https://www.managedfunds.org/wp-content/uploads/2014/03/Credit-Suisse-2014-Investor-Survey-Report.pdf accessed 18 April 2015; Preqin, 'Preqin Special Report: Hedge Funds in the US' (October 2016) <https://www.preqin.com/docs/reports/Preqin-Special-Report-Hedge-Funds-in-the-US-October-2016.pdf>

[127] Kahan and Rock (n 81).

[128] Bebchuk (n 6), 688-9; Kahan and Rock (n 81), 1072-1082; Bebchuk et al., (n 6), 1086-90.

[129] Kabi Kastiel and Yaron Nili, '"Captured Boards": The Rise of Super Directors and the Case for a Board Suite' (2017) *Wisconsin Law Review* 16 (Forthcoming 2017).

[130] Sam Forgione, 'Carl Icahn says no better time to be an activist investor' *Reuters* (26 December 2014) < http://www.reuters.com/article/us-icahnenterprises-results-idUSBRE9A312F20131104> accessed 10 January 2017.

[131] Kahan and Rock (n 81), 1026.

[132] Gregory Shill, 'The Golden Leash and The Fiduciary Duty Of Loyalty' (2017) 64 *UCLA Law Review* (forthcoming) 4.

4.3.2.5.1 Why are Hedge Funds Different?

Hedge funds are pooled investments that are privately established and managed by professional investment managers who are also general partners and are compensated according to performance. This generally consists of a 1-2% management fee of the capital invested in and 15-20% performance fee of the returns. The funds are not widely available to the public and are limited to a number of sophisticated and wealthy investors.[133] Unlike other institutional investors, hedge funds charge a performance fee, which means that they can focus on absolute returns and thereby have the opportunity to generate returns from their investments regardless of the market conditions and relative performance of their competitors. As a result, they are not afraid of supporting relatively high-risk strategies in their investee companies. They do not usually have a business relationship with the management of the target company, and so they are subject to fewer less conflicts of interest than other institutional investors who provide fund management services to companies. Managers of hedge funds therefore have strong incentives to undertake activism. The activist hedge funds are information traders.[134] They are willing to collect general market and firm-specific information for investment decisions and to engage in a high degree of shareholder activism to bring about changes in corporate governance. In essence, they trade on the basis of their informational advantage as to the difference between the market value and the potential value of the target company. So hedge funds usually approach target companies with a list of demands that can generate shareholder value in a certain period. This process has a broader impact on the market and makes it more efficient by expanding the available information and correcting prices in the market.[135]

Lock-up provisions provide protection to the fund against the untimely demands of investors to withdraw their investment for 6 to 24 months, and enough

[133] Dionysia Katelouzou, 'Myths and Realities of Hedge Fund Activism: Some Empirical Evidence' (2013) 7 *Virginia Law & Business Review* 459.
[134] Zohar Goshen and Gideon Parchomovsky, 'The Essential Role of Securities Regulation' (2006) 55 *Duke Law Journal* 711; Paul Rose and Bernard Sharfman, 'Shareholder Activism as a Corrective Mechanism in Corporate Governance.' (2014) 2014 *Brigham Young University Law Review* 1015, 1031.
[135] Goshen and Parchomovsky (n 134), 719.

freedom to exert influence on management without being subject to pressure from investors.[136] Yet they cannot be long-term investors like quasi-index investors because, once they carry out a successful campaign to remove factors causing managerial inefficiencies, they start another campaign in a different company in order to receive abnormal returns. This investment strategy is not possible for long-term quasi-index funds, and therefore they are less likely to carry out such corrective activism. The quasi-index funds may need to leave this function to activist hedge funds. The average holding period of hedge funds is longer than conventional wisdom might suggest. Some empirical studies indicate that the average holding is between one and two years.[137] Finally, hedge funds are usually subject to less regulation over the types of investments they can choose. When structuring the hedge fund, it is important to form the fund in a manner that reduces the number of restrictions with which the fund must comply.[138] They take advantage of exemptions, exclusions and safe harbours in the regulations, and may also prefer to establish the funds in offshore jurisdictions to benefit from favourable tax regimes.[139] It is a common assumption that hedge funds are unregulated and unsupervised investment vehicles, unlike mainstream funds, though 'lightly regulated' is a better description for hedge funds in the US and UK, given the regulatory changes in those jurisdictions.[140] As a result of less regulation, they can build up larger stakes than other mainstream shareholders. The

[136] Jonathan Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press 2008), 413.
[137] See Katelouzou (n 133), 464;
[138] Timothy Spangler, 'Hedge Funds' in Spangler (n 62), 1196.
[139] Financial Services Authority (FSA), 'Hedge Funds and FSA' (2002) Discussion Paper No. 16, 12.
[140] Anne Riviere, 'The Future of Hedge Fund Regulation: A Comparative Approach' (2010) 10 *Richmond Journal of Global Law and Business* 263; Davies, (n 13) at 377. For example, the advisers have been able to escape from the registration requirement if they had 15 or less clients, even if some are funds. Title 4 of the Dodd–Frank Wall Street Reform and Consumer Protection Act eliminated this exemption. Therefore fund advisers, in principle, are required to register with the SEC. In addition, shares in hedge funds can be regarded as falling within the scope of the definition of section 2(a)(1), which technically makes hedge funds subject to the Securities Act 1933 (the 1933 Act). Hedge funds do not make public offerings, and therefore, securities of the funds are offered through private offering which has an exemption under section 4(2) of the 1933 Act. The final regulation is the Exchange Act. If hedge funds were considered as dealers, they would need to register under section 5(b) of the Exchange Act. As regards the UK regulation, the UK has preferred to interfere in this sector so far only at a minimal level. In the post-crisis period, tighter regulation of hedge funds has been called for in the EU. The sector's friendly reputation was damaged as a result of the Alternative Investment Fund Managers' Directive (AIFM). It imposed requirements with regard to the safekeeping of assets, leverage, valuation and pricing. In short, it seems that the common assumption as to hedge fund regulations is debatable, given the recent regulatory movements in the UK and US.

average hedge fund block is generally between 7-9%, which means that they are less likely to have a sufficient stake to gain control.[141]

In conclusion, due to the incentive structure of hedge funds, relatively light regulation, relatively concentrated stakes in a small number of companies, well-developed research skills, and fewer conflicts of interest, they are less beholden to management and are not afraid of carrying out confrontational activism. Hedge funds carry out a hybrid form of 'internal monitoring by large shareholders and external monitoring by corporate raiders … This hybrid internal-external role puts activist hedge funds in a potentially unique position to reduce the agency costs associated with the separation of ownership and control'.[142] They exercise a significant disciplinary function in corporate governance and the market. The business model of hedge funds accounts for why hedge funds can employ offensive activism.

4.3.2.5.2 The Process of Hedge Fund Activism

The factors above make up the business model of hedge funds that enable them firstly to identify potential targets for engagement, secondly to accumulate a sizable stake, thirdly to employ activist strategies, and finally to exit.[143]

a- Identifying the Target Company

It is crucial for an activist hedge fund to identify an undervalued (underperforming) target. They assess the market value of the target company, which is lower than its possible value after a successful intervention based on the information they have, and they then acquire the undervalued shares,[144] buying significant stakes. In doing so, they provide an alternative view to the market about the actual value of the company's shares. At this stage, mandatory disclosure requirements play a key role in identifying targets and evaluating potential agency conflicts, executive remuneration, and business strategy in the course of an activist campaign.

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[141] Thomas Briggs, 'Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis' (2007) 32 *The Journal of Corporation Law* 682, 697.
[142] Brav et al (n 156), 264.
[143] Dionysia Katelouzou, 'Worldwide Hedge Fund Activism: Dimensions and Legal Determinants' (2015) 17 *University of Pennsylvania Journal of Business Law* 789.
[144] Goshen and Parchomovsky (n 135), 723.

b- Accumulating Stakes in the Target Company

Following the identification of the target company, the fund begins to accumulate a sizeable stake as a means to initiate change. It is important for the fund to buy the stake without alerting the market because the announcement of such activism usually triggers an immediate increase in the share price.[145] Such a share price increase after an announcement of shareholder activism can be as much as around 10%.[146]

Securities law, and in particular disclosure rules at the entry stage, can facilitate or deter the accumulation of shares by hedge funds. The rules of initial threshold disclosure, the deadline for such disclosure after crossing the threshold, and the scope of disclosure, all play a role in a hedge fund's ability to build up a stake. In the US, under section 13(d) of the Securities Exchange Act of 1934[147] and related regulations,[148] any person acquiring in excess of 5% ownership must disclose it within 10 days of the acquisition.[149] This arguably provides the opportunity for hedge funds to extract sufficient benefits from the activism to make it a worthwhile exercise. The 5% ownership threshold and the 10-day time window make US corporate governance one of the most activism-friendly in the world.[150] For instance, the UK adopted more stringent rules on disclosure. According to the Disclosure and Transparency Rules, the disclosure threshold is relatively low (3%) and the disclosure must be made after acquiring a 3% or greater stake.[151] It is important for an activist investor to be able to amass a large stake anonymously because share prices usually increase after activism is announced.[152] Hedge funds can employ financial derivatives and other synthetic transactions allowing investors to decouple the economic risk of having shares from voting rights in order to avoid disclosure requirements and increase leverage, as

[145] John Coffee 'Hedge Fund Activism: What Do We Know and Not Know' in William Bratton and Joseph McCahery (eds) *Institutional Investor Activism* (OUP 2015) 693.
[146] April Klein and Emanuel Zur, 'Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors' (n 145) 305.
[147] 15 U.S. Code § 78m (d).
[148] 17 C.F.R. § 240.13d.
[149] Section 13(d) 1 of the Securities Exchange Act of 1934, 17 CFR 240.13d-1.
[150] Alessio Paccess, 'Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance' (2016) 4 *Erasmus Law Review* 199, 212.
[151] Chapter 5 of the Disclosure and Transparency Rules of FCA Handbook; see Davies (n 13) 377.
[152] Klein and Zur (n 146) (noting that the share price usually increases with Schedule 13D filing and the increase lasts in the subsequent year for all shareholders).

discussed in Chapter 3.[153] Another method is the 'wolf-pack' approach, which will be discussed below.

c- The Disciplining Stage

Hedge funds engage in strategic and governance changes after the accumulation of a stake in the target company. They develop firm-specific strategies to address governance gaps that have arisen from deficits in the monitoring of managerial agency problems.[154] This is why they are often referred to as 'entrepreneurial activists' or 'governance entrepreneurs'.[155] They are fundamentally different than other institutional investors in terms of the type of activism they carry out. In this regard, hedge funds look upon activism as primarily an investment approach delivering abnormal returns,[156] unlike other institutional investors that view activism as an ongoing process to monitor management with the aim of protecting their investments in portfolio companies and the savings of the beneficiaries or advancing a social agenda. They mostly prepare alternative business strategies, and then present the strategies to the board and shareholders. In this regard, hedge funds help other mainstream investors to overcome rational shareholder passivity by presenting them with an alternative business strategy or nominating independent directors. As discussed above, the development of firm-specific activism could be expensive for some shareholders but responding to such shareholder proposals is not. Hedge funds therefore help mainstream investors to transform from 'rationally passive' to 'rationally reticent'.[157]

The proposed changes alert the board that there may be managerial inefficiencies in the eyes of shareholders. As the foundation of hedge fund activism is the difference between the share price and the fundamental value of a company, hedge fund activism will address and correct strategic and governance shortfalls in coordination with mainstream investors. In this context, hedge fund activism could be

[153] See, Henry Hu and Bernard Black, 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions' (2008) 156 *University of Pennsylvania Law Review* 625.
[154] Gilson and Gordon (n 11) 896.
[155] April Klein and Emanuel Zur, (n 146).
[156] See generally Alon Brav et al, 'Hedge Fund Activism, Corporate Governance, and Firm Performance' in Bratton and McCahery (eds) (n 71) 261.
[157] Gilson and Gordon (n 11) 867.

a valuable mechanism in corporate governance when the proposed changes aim to address agency problems. At the same time, they are very controversial institutional investors due to the way they involve themselves in management.

Activist investors are increasingly gaining power in their portfolio companies and challenge management and boards to implement changes. For instance, 319 high impact activism initiatives against US companies occurred in 2016.[158] The proposed changes go informally to the board at first; the activist attempts to persuade the board to adopt the recommended changes. At this stage, they are mostly advisory in nature and the activism is not meant to be confrontational. The funds' campaign is not confined to the annual general meetings. They usually start with soft activism and then ramp up to a more aggressive form. Finally, if they cannot get concessions from the board, they usually heighten the level of activism and the last step is waging a proxy contest. At this point, the success of their campaign depends on whether they can get enough support from other investors. Hedge funds may therefore not succeed in reaching all of their targets, even using all the legal options at their disposal.

The agenda of hedge funds ranges from major changes, such as the sale of a company, blocking an acquisition, spinning off a division or removing the CEO, to lesser changes such as altering the capital structure of the company, increasing R&D projects, share buy-backs, adjusting dividend policy, and fixing governance issues including board independence, executive compensation, or direct representation on the board.[159] The success rate of activism is remarkable. For example, TCI, a hedge fund, amassed 5% of Deutsche Börse and blocked its acquisition of the London Stock Exchange.[160] A dramatic increase in the success of activist campaigns has been

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[158] FactSet, '2016 Shareholder Activism Review' (2016) <https://insight.factset.com/hubfs/Resources/Research%20Desk/Market%20Insight/FactSet%27s%202016%20Year-End%20Activism%20Review_2.1.17.pdf> accessed 08 May 2017.

[159] Iris HY Chiu, *The Foundations and Anatomy of Shareholder Activism* (Hart Publishing 2010) chapter 3.

[160] Grant Ringshaw, 'Rebels threaten Deutsche Börse bid for LSE' *The Telegraph* (London, 16 January 2005).

observed. In many cases, activist funds secured board representation, either through negotiation and settlement or through a proxy fight.[161]

The candidates nominated by activist funds have the potential to improve corporate governance and increase the monitoring capacity of the board. As discussed in Chapter 2, in the traditional law and economics approach, the rise of independent directors remains an unfulfilled promise and director elections are often uncontested and unchallenged. The future directors are therefore usually predetermined by the current board and top executives. Hedge funds are not afraid of launching a proxy fight to nominate directors. This enlarges the pool of candidates who are usually competent industry experts or corporate veterans who have more relevant industry knowledge but generally have no relationship to the fund.[162] This also helps mainstream investors who are not willing to carry out a proxy contest against the management. Moreover, directors nominated by shareholders serve an important role which is not widely discussed in the literature. They may address the information gap between the board and management and the structural problems of the monitoring board discussed in Chapter 2.[163] These candidates do not have to rely on the management for their appointment; they can therefore easily speak out against management and ask for more information.[164] More importantly, they have access to the full resources of hedge funds to collect new information and can analyse the information given by management to the board. These candidates can reduce the reliance of the board on management and can bring new information to the board which is a key component of informative and complete discussions. As these directors often get bonus pay, they have enormous financial incentives to increase corporate performance. Trian Fund Management, led by Nelson Peltz, is a typical example of board nominations. In 2006, Trian Fund Management accumulated a stake in Heinz. Subsequently, it expressed concerns about

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[161] FTI Consulting, *2015 Shareholder Activist Landscape: An Institutional Investor Perspective* (2015) http://www.fticonsulting.com/~/media/Files/us-files/insights/reports/shareholder-activism-2015.pdf accessed 15 January 2017.
[162] Shill (n 181) 19.
[163] Yaron Nili, 'Servants of Two Masters? The Feigned Hysteria Over Activist-Paid Directors' (2016) 18(2) *JBL* 510; Adam Prestidge, 'Activist Compensation of Board Nominees and the Middle Ground Response' (2015) 11(2) *Hastings Business Law Journal* 306.
[164] Kastiel and Nili (n 129) 19.

the disappointing earnings of the company since 1998.[165] The board at that time thought that they 'don't need outside help'. However, Trian analysed boxes of old board meetings and financial statements and provided new information about what had gone wrong. The company was eventually sold at a 19 % premium in 2013.[166] Moreover, in 2015, the CEO of General Electrics invited Trian to purchase a stake in the company and seek board representation.[167] This clearly shows how sophisticated investors could play a role in dealing with informational gaps between the board and management by analysing information, and by addressing structural problems of the modern board of directors. The Trian example is also an important contribution to our understanding of how shareholder activism is evolving in US corporate governance.

Hedge funds engage in governance issues, such as the independence and expertise of the board members, and anti-takeover mechanisms to be able to influence the long-term strategy or general policies of the target company to achieve higher absolute returns by demanding dividends or share purchases afterwards. In the course of their activism, they may reveal many deficits in the board or weaknesses of corporate governance. For instance, a letter written by Third Point LLC, a hedge fund, to Star Gas revealed that the CEO had appointed his 78-year-old mother to serve on the board of directors.[168] After this engagement, the CEO had to resign. It shows that the board itself sometimes cannot resist the management's demands even in extreme situations.

Many authors believe that the proposed changes in fact cause short-termism, a reduction in long-term projects at the macro-economic level, and a shift of value from the company to activist investors.[169] Chiu argues that hedge fund activism can involve

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165 David Benoit, 'Activism's Long Road from Corporate Raiding to Banner Year' *The Wall Street Journal* (26 December 2015) https://www.wsj.com/articles/activisms-long-road-from-corporate-raiding-to-banner-year-1451070910 accessed 18 January 2017.
166 David Benoit, 'Activism's Long Road from Corporate Raiding to Banner Year', *The Wall Street Journal* (26 December 2015), http://www.wsj.com/articles/activisms-long-road-from-corporate-raiding-to-banner-year-1451070910 accessed 18 January 2017.
167 Benoit (n 166).
168 Third Point LLC, 'Letter to Mr. Irik P. Sevin Chairman, President and CEO Star Gas Partners' (SEC, 14 February 2005) < https://www.sec.gov/Archives/edgar/data/1002590/000089914005000128/t2774169.txt>.
169 Coffee (n 145) 694.

value extraction from the company to shareholders through reallocating the company's assets, for example, selling a division, spinning off a department or reducing the R&D budget.[170] This type of value extraction naturally raises concerns.[171] These concerns also have regulatory implications and shape lawmakers' opinions regarding shareholder activism. For instance, the recommendation of the Starboard Value, a hedge fund, that the Winsconsin-based Wasau Paper company should close the Brokaw Mill and focus on its tissue business rather than free sheet-printing paper business because the global market for free-sheet paper had been shrinking, inspired lawmakers to reduce the impact and influence of shareholders in the proposed 'Brokaw Act'[172] which aims to tighten disclosure rules.[173] It is therefore better to approach hedge fund activism with caution. It is also quite possible that it may aim to advance private interests, as occurred in the Mylan case discussed in Chapter 3.

Hedge funds often employ controversial techniques to increase their influence over the target company and carry out their objectives. These techniques are categorised as: risk-decoupling strategies, golden leashes, and wolf-packs. Since risk-decoupling techniques have been discussed in Chapter 3, they will not be repeated here. Wolf-packs are loose coalitions of hedge funds. As mentioned above, a standalone hedge fund rarely builds up a controlling stake reaching 20%.[174] In some cases, they may prefer to establish loose coalitions without formal agreements between them in order to avoid the disclosure requirements of securities laws. The members of the wolf-pack quickly purchase stakes in the target firm before the wolf-pack leader discloses its ownership as required by securities laws. These tactics help hedge funds to share informational and financial resources, which in turn greatly reduces the cost of activism. The members of the wolf-pack receive significant gains from the increase

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[170] Chiu (n 159) 140.

[171] Martin Lipton, 'The Threat to Shareholders and the Economy from Activist Hedge Funds' (HLSFCGF, 14 January 2015) < https://corpgov.law.harvard.edu/2015/01/14/the-threat-to-shareholders-and-the-economy-from-activist-hedge-funds/>.

[172] S.2720 — 114th Congress (2015-2016).

[173] Alon Brav et al., 'Anti-Activist Legislation: The Curious Case of the Brukaw Act' (2017) < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860167> accessed 10 May 2017.

[174] William Bratton, 'Hedge Fund Activism, Poison Pills, and the Jurisprudence of Threat' (2016) *University of Pennsylvania Law School Research Paper No. 16-20,* 10.

in share prices that follow the announcement of the activism.[175] This is arguably a 'low-risk high-profit' opportunity.[176] Coffee and Palia argue that hedge funds collectively could obtain 30% of a target company and that this may give rise to an effect similar to a controlling acquisition in which ordinary shareholders receive little or no control premium.[177] It gives hedge funds significant bargaining power and places management in a weaker position in negotiations because management knows a group of activist shareholders owns the company's shares and it needs to meet their demands.[178] The members of wolf-packs carry relatively less economic risk in relation to their bargaining power because even in the worst case scenario where the members of the wolf-pack do not have a superior strategy or information, they will reap the benefits of share price increases after the announcement of their shareholder activism.[179] As the formation of the wolf-pack is relatively easy, it may be overused which in turn may cause a systemic decrease in long-term investments leading to a situation in which the wolf-pack extracts value from other shareholders and from the company itself.

The third controversial technique is the golden leash tactic. In this stratagem, hedge funds offer a lucrative compensation package to nominee directors on top of the executive remuneration received from the company[180]. The supplemental package depends on corporate performance and the accomplishment of the objectives described by the appointer.[181] Since hedge fund nominee directors may implement a number of changes as instructed by the activist fund and in return for additional payment, concerns have been raised regarding short-termism and the private interests of shareholders. One could argue that when a conflict arises, the nominee director will

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[175] John Coffee and Darius Palia, 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2016) 41(3) *The Journal of Corporation Law* 546, 551.
[176] Coffee (n 145) 701.
[177] Coffee and Palia (n 175) 593.
[178] Coffee (145)703.
[179] Coffee (n 145) 701.
[180] Nili (209) 525; John Coffee, 'Shareholder Activism and Ethics: Are Shareholder Bonuses Incentives or Bribes' (*The CLS Blue Sky Blog*, 29 April 2013) http://clsbluesky.law.columbia.edu/2013/04/29/shareholder-activism-and-ethics-are-shareholder-bonuses-incentives-or-bribes/ accessed 08 November 2016.
[181] Gregory Shill, 'The Golden Leash and The Fiduciary Duty Of Loyalty' (2017) 64 *UCLA Law Review* (forthcoming).

favour the interests of the fund rather than the interests of the company and other shareholders. An elected director could feel beholden to his or her sponsor or obliged to follow her or his sponsor's strategy regarding the target company. Coffee likened the golden leash to bribery and argued that 'third party bonuses create the wrong incentives, fragment the board, and imply a shift towards both the short-term and higher risk.'[182] Similarly, Bainbridge described it as 'nonsense' and argued that '[i]f this nonsense is not illegal, it ought to be'.[183] Hedge fund-nominated directors therefore have to be approached with caution because they may have questionable motives.

In conclusion, hedge funds take an active stance in corporate governance. As a result of their business models, they are well suited to develop the skills needed to identify and address strategic and governance shortfalls, to buy a sizeable stake to influence management, to prepare proposals, and to present them to other institutional investors. Their primary target is to obtain abnormal returns by addressing managerial accountability problems, and then to leave the company. They are not afraid of launching proxy contests and nominating independent directors. In this way, they may help the board to bridge any information asymmetry between the board and management thereby serving an important role in reducing agency cost problems by enhancing the board's monitoring ability. They are less likely to be long-term investors as envisaged by the Stewardship Principles or Code and to engage in responsible shareholder activism. It seems quite possible that they may use their influence to advance their private interests. They also employ empty voting, wolf-pack and golden leash tactics to increase their influence over management without bearing all the economic consequences. In that regard, they may need to be approached with cautioun.

[182] John Coffee, 'Shareholder Activism and Ethics: Are Shareholder Bonuses Incentives or Bribes?' (The CLS Blue Sky Blog, 29 April 2013) < http://clsbluesky.law.columbia.edu/2013/04/29/shareholder-activism-and-ethics-are-shareholder-bonuses-incentives-or-bribes/> accessed 6 October 2016.

[183] Stephen Bainbridge, 'Can corporate directors take third party pay from hedge funds?' (Bainbridge Blog, 04 July 2013) < http://www.professorbainbridge.com/professorbainbridgecom/2013/04/can-corporate-directors-take-third-party-pay-from-hedge-funds.html> accessed 10 January 2017.

4.4 Conclusion

Share ownership in the US has evolved from one that is individual to one that that is institutional in nature. The accumulation of share ownership in the hands of institutional shareholders makes shareholder activism economically more rational. However, some types of activism could still be expensive for some institutional shareholders because of the different characteristics of institutional shareholders.

Each type of institutional shareholder has different features. It has been shown that mainstream investors namely, pension funds, mutual funds, insurance companies, and SWFs, are generally long-term investors. They are usually interested in governance issues. In particular, large mainstream institutional shareholders could exercise a stewardship role in corporate governance because they have enough resources and are usually internally managed. They have the potential to contribute to the decision-making of investee companies. These mainstream investors have transformed from 'rationally passive investors' to 'rationally reticent investors' with the help of regulations, political pressure and the emergence of activist funds.

The reluctance of institutional investors to reduce the agency cost problem even when it is beneficial for ultimate owners, creates a governance gap as well as an arbitrage opportunity in the investment chain. Hedge funds can take advantage of this opportunity because of their unique business models. The fee structures and disclosure regime are vital for hedge funds for the sustainability of their business model. In this regard, the US disclosure regime is one of the most activist friendly regimes in the world.

Hedge funds play a crucial role in corporate governance by pointing out the potential shortfalls in the monitoring of managerial accountability problems and raising legitimate questions in the boardroom and between shareholders. More importantly, they can identify the lack of quality or expertise of directors and nominate new directors, which could potentially address structural problems in the board. Their proposed changes are usually controversial and could be value-reducing for some companies while advancing the funds' own interests. Moreover, activist funds employ empty voting, wolf-pack and golden leash tactics to increase their influence without proportionately bearing the economic consequences of their proposals. Thus, activist funds should not be unconditionally favoured in corporate governance.

Overall, there is a division of labour between different shareholders in the market. Hedge funds could potentially complete shareholder activism in the market. In this respect, they could potentially bridge the gap between ownership and control. Mainstream institutional shareholders are the arbiter of activist proposals and could support the board where these proposals are value-reducing. The role of awakening mainstream investors and the emergence of activist funds should be taken into consideration by lawmakers.

Chapter 5. Shareholder Activism in US Corporate Governance

5.1 Introduction

The primary aims of this chapter are to explore (i) the extent to which shareholder activism is practicable under US company law and (ii) the judicial interpretation of the traditional director primacy theory. Chapter 3 concluded that shareholder activism is a valuable corporate governance mechanism and is now considered a self-help mechanism for the protection of shareholder interests and an accountability mechanism that provides stability and sustainability to companies in the market.[1] Chapter 4 discussed the emergence of activist funds and how mainstream institutional investors transformed from 'rationally passive investors' to 'rationally reticent investors'. This raises the question of whether these market and policy developments can be accommodated under the current US corporate governance.

US corporate governance traditionally regards shareholders as 'spectators' or 'bystanders'.[2] Shareholder activism has therefore always been controversial, while the protection of shareholder value has been at the centre of US corporate governance.[3] The increasing power of institutional shareholders and managerial accountability concerns are the drivers behind the recent changes in US corporate governance.[4] This change is happening through legal reforms and the market-driven process of shareholder proposals. Institutional shareholders increasingly seek to change corporate governance on a company-by-company basis. There are therefore some differences between the law in the books and the law in action. However, this is not

[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter referred to as 'the Dodd-Frank Act'), Pub. L. No. 111-203 (2010).
[2] Christopher Bruner, *Corporate Governance in the Common-Law World* (Cambridge 2013) 38; Mathias Siems, *Convergence in Shareholder Law* (Cambridge 2011) 63; Jennifer Hill, 'Visions and Revisions of the Shareholder' (2000) 48(1) *The American Journal of Comparative Law* 39, 47.
[3] The preamble to the Sarbanes-Oxley Act states that the aim of the Act is 'to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.' Sarbanes-Oxley Act of 2002, Public Law No 107-204, 116 Stat. 745.
[4] Jennifer Hill, 'The Rising Tension between Shareholder and Director Power in the Common Law World' (2010) 18(4) *Corporate Governance: An International Review* 344; Stephen Bainbridge, 'Preserving Director Primacy by Managing Shareholder Interventions' in Jennifer Hill and Randall Thomas (eds) *Research Handbook on Shareholder Power* (EdwardElgar 2015) 231.

the end of the story because the default regime, judicial sympathy to director primacy, and the business community still favour the board and management.

This chapter will focus on the three issues. The first section will examine legal and governance rules that reflect director primacy theory; the second will analyse how shareholder activism functions in the US; and the third section will discuss whether recent developments mean a paradigm shift in US corporate governance.

5.2 Legal and Governance Rules that Reflect Director Primacy Theory

A brief description of the US legal system is needed here to better understand how internal corporate governance is regulated. US corporate law is a mix of state and federal law. State law traditionally regulates the realm of internal corporate governance affairs.[5] At federal level, the SEC is authorised by section 14(a) of the Securities Exchange Act of 1934[6] to regulate the solicitation and issuance of proxies, among other matters. The federal rules primarily regulate the proxy rules. Since listed companies' shareholders mainly use their rights through proxies, the federal regulations are of vital importance in the exercise of shareholder rights.[7]

The most important descriptive feature of the US legal framework of corporate governance is its extensive reliance on board authority.[8] US corporate governance is usually described by the weak governance power of shareholders and a lack of straightforward tools to intervene in corporate affairs.[9] In addition to weak legal power, US courts have also been responsible for 'relegating shareholders to the questionable role of bystander'[10] through the application of the business judgment rule.[11] In the development of director-centric rules, the negative and weak images of

[5] Marc Moore, *Corporate Governance in the Shadow of the State* (Hart 2013) 180.
[6] 15 U.S.C. 78n(a)
[7] Paul Rose, 'Shareholder Proposals in the Market for Corporate Influence' (2014) 66 *Florida Law Review* 2179, 2186.
[8] Stephen Bainbridge, *The New Corporate Governance: in Theory and Practice* (OUP 2008) 53-4.
[9] Bruner (n 2) 36; see generally note 2.
[10] Bruner (n 9) 37; Mathias Siems, *Convergence in Shareholder Law* (CUP 2011) 63.
[11] Richard Buxbaum, 'The Internal Division of Powers in Corporate Governance' (1985) 73(6) *California Law Review* 1671, 1683.

shareholders have played a crucial role and have been used by the business management community to lobby for their interests.[12]

The rest of this chapter will focus on the legal and governance rules that reflect director primacy.

5.2.1 The Board of Directors

The board of directors is, arguably, the most important body in modern listed companies. The Delaware General Corporation Law (DGCL) attributes managerial power to the board of directors: 'the business and affairs of every corporation organised under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation'.[13] Unlike UK company law where the division of powers is left to be decided under the company's constitution, US law expressly allocates the management and oversight powers to the board of directors. In this regard, the board's authority is original and undelegated from shareholders. This is an important aspect of the director primacy model in US corporate governance.

Despite its axiomatic importance to the functioning of corporate governance, the law is remarkably silent on the proper composition of the board besides a basic rule that a company should have directors.[14]

5.2.2 Composition of the Board of Directors: From an Advising to a Monitoring Board

The role and composition of the board differ greatly than was the case in the 1950s. In the past, the members of the board of directors used to be chosen by the CEO and tended not to challenge his/her authority.[15] Thus, the board was often considered 'an

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[12] John Armour and Joseph McCahery, 'Introduction' in John Armour and Joseph McCahery *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Hart Publishing 2006) 7.
[13] Section 141(a) of the Delaware General Corporation Law; this section also constitutes an important pillar of the director primacy theory. See, Stephen Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' (2003) 97 *Northwestern University Law Review* 547, 559.
[14] Section 141 of the DGCL.
[15] Jeffrey Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: of Shareholder Value and Stock Market Prices' (2007) 59 *Stanford Law Review* 1465, 1511.

extension of management'.[16] The board's role was advisory rather than one of monitoring of management.[17] A number of factors have resulted in the board moving from a predominantly advisory to a monitoring role. First, corporate governance failures since the 1970s have revealed that advisory boards to have difficulty in realising the real financial situation and performance of the company and often a failure to grasp the underperformance of management.[18] Second, in the wake of hostile takeovers, the judiciary promoted board independence by 'sustaining of unprecedented defensive measures in the cases of the 1980s'.[19] Third, the market for corporate control was found too expensive as a means of dealing with agency problems. Finally, as a response to the Enron failure, stock exchange rules required the majority of board members to be independent, with independent nomination, audit and compensation committees, and an enhanced independence requirement for directors.[20] Stock exchange markets take a rules-based approach and provide details as to circumstances which affect the independence of directors. While the New York Stock Exchange (NYSE) applies 'no material relationship with the listed company' as the independence criterion, NASDAQ bars any relationship that would impair independence.[21] Although independence is not required by the law as such, the board must not have a conflict of interest in order to be protected by the business judgment rule which will be discussed below. It should be noted that the courts apply vague legal standards for independence when compared to the stock exchanges' stricter criteria.[22] In short, the board's function has evolved from an advisory function to a monitoring role over the past half century and independent directors have become critically important in the composition of the board.[23]

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[16] Gordon (n 15) 1511.
[17] Bainbridge (n 8) 159.
[18] Gordon (n 15) 1515.
[19] Gordon (n 15) 1524.
[20] Rule 303A.02, 303A.04 and 303A.05 of the NYSE Listed Company Manual; see also Rule 5605(b) of the NASDAQ Marketplace Rules.
[21] NYSE 303A.02(a); NASDAQ 5605(a)(2).
[22] *Beam ex rel. Martha Stewart Living Omnimedia, Inc v Stewart* 845 A. 2d 1040, 1050 (Del. Supr. 31 March 2004) where the court stated that 'allegations of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence'.
[23] Ronald Gilson and Reiner Kraakman, 'Reinventing the Outside Director: An Agenda for Institutional Investors' (1991) 43 *Stanford Law Review* 863.

The board of directors carries out two principal functions: deciding on strategic corporate policies and actions, and monitoring management on an ongoing basis.[24] Much of the oversight and governance roles of the board are fulfilled through audit, compensation and nomination committees which are composed of independent directors.[25] Their oversight role has become more relevant in particular for companies that severely underperform. They can take radical measures, including the removal of top managers.

In the UK, the separation of chairman and CEO is recommended by the UK Corporate Governance Code.[26] By contrast, it used to be commonplace in the US for CEOs to serve as chairs of the board. However, amendments to the SEC rules in 2010 triggered the separation of the chairman and CEO positions. Boards are now required to disclose their role in the risk oversight of the company and whether their leadership structure is appropriate to monitor the management.[27] Following the financial crisis, the separation of chairman and CEO positions has drawn the attention of activist funds and mainstream investors. The number of S&P 500 companies with separate chair and CEO roles was around 29% in 2005 but this increased to 48% in 2015.[28]

The board has been pushed to be independent, at least as an aspiration, and it is now more competent to carry out a monitoring role than ever before. The monitoring role of the board, which is the raison d'être of independent directors, can be diminished by management through the appointment of directors or by the information asymmetry between the independent directors and the top management. The board can therefore be trapped by the management even if independent directors are in the majority. The Enron and Lehman failures revealed the captive board problem: even though the board

[24] Howard Friedman, *Publicly Held Corporations* (Oxford 2011), 85-6.
[25] NYSE 303A.04, 303A.05, 303A.06; Rule 5605 (c), (d), and (e) of NASDAQ.
[26] Principle B.1.1. of the UK Corporate Governance Code
[27] 17 CFR 229.407(h); see also SEC, *Proxy Disclosure Enhancements*, Release No. 33-9089 (16 December 2009).
[28] SpencerStuart, '2015 SpencerStuard Board Index' (2015) 20 https://www.spencerstuart.com/~/media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015_110215-web.pdf accessed 30 August 2016.

was aware of questionable transactions by the management, the board adopted a very lax approach to its oversight role.[29]

5.2.3 Locus of Management

The locus of management emerges from the requirements of listed companies. Management, unlike the board of directors and shareholders, is not legally defined as an authority. Although it is stated that the board is responsible for the management of the company, the management of large listed companies is beyond the capacity of a limited number of board members. Therefore, the phrase '… or under the direction of … [the board]' was added to section 141(a) of the DGCL for the delegation of managerial functions to managers.[30] The delegation of power to management is the norm in the US.[31]

In reality, managers, i.e. corporate officers, dominate the board through their de facto power and carry out day-to-day corporate actions according to delegated authority.[32] As a result of the broad's delegation of power, executive managers decide on business strategies and the general direction of companies, establish business goals, manage risk, and coordinate production.[33] Moreover, they provide information and recommendations to the board about the investment and business strategies that a company should follow and then implement these projects after the board's approval.[34] In short, managers appear to take most decisions under the control of the directors and provide information and recommendations about major issues to the board.

The separation between the roles of managers and the board has arisen from economics and corporate governance principles rather than law itself. The board therefore maintains the formal and legal authority, and also actual authority over major

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[29] Marilyn Cane and Stacey Silva, 'Shareholder Democracy and The SEC's Proxy Rules: in the Boardroom' (2010) 15 *Fordham Journal of Corporate & Financial Law* 241, 242.
[30] Stephen Bainbridge, *Corporate Law* (3rd edition, Foundation Press 2015) 73.
[31] Lyman Johnson and Robert Ricca, 'Reality Check on Officer Liability' (2011) 67 *Business Lawyer* 75, 77-80.
[32] Barry Baysinger and Robert Hoskison, 'The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy' (1990) 15 *Academy of Management Review* 72, 72-3.
[33] Johnson and Ricca, (n 31) 77.
[34] This situation has been often stated in the principles of corporate governance of large public companies. See Robert Thompson, 'Anti-Primacy: Sharing Power in American Corporations' (2016) 71(2) *Business Lawyer*, 71(2) 381, 398-400.

corporate decisions such as mergers and acquisitions, spin-offs from the company, substantial changes in business strategies and executive remuneration. Importantly, the board's oversight role continues, and it cannot abdicate itself from responsibility by delegating to the management.[35]

As a result, in the US, many managerial tasks in large companies are carried out by the executive managers. As such, directors are only involved in major corporate decisions. The board relies on the information and recommendations provided by management in shaping general business strategy and taking major corporate decisions.

5.2.4 Judicial Deference to the Board of Directors: The Business Judgment Rule

The DGCL attributes managerial power to the board of directors, but this is only a default regulation. The defining feature of US corporate governance is that the decision-making authority lies beyond shareholders' intervention. In return, US company law tries to keep them accountable under the duty of care. However, US courts are reluctant to assess the propriety of managerial decisions in relation to the corporate objective and strategy. US courts apply three tiers of review for evaluating decision-making: the business judgment rule, enhanced scrutiny and entire fairness.[36] The business judgment rule is the standard of review which generally assumes that the board is independent, disinterested and sufficiently informed. Unless proven otherwise, the business judgment rule protects the decision-making authority of the board. It provides the most capacious foundation for corporate decision-making. Therefore, the primary focus here will be on the business judgment rule. Other relevant standards of review for corporate decision-making will be examined briefly below.

The default regime is laid down by Section 141(a), but courts often fill the gaps that arise from the issues that were not identified ex ante or hears claims as to the

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[35] *Francis v. United Jersey Bank*, 87 N.J. 15, 31 (1981) the court held that 'directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look.'; *Graham v Allis-Chalmers Manufacturing Co.,* 188 A. 2s 125, 130 (Del. Sup. 1963).

[36] *Reis v. Hazelett Strip–Casting Corp*., 28 A.3d 442, 457 (Del.Ch.2011); see also Travis Laster, 'The Effect of Stockholder Approval on Enhanced Scrutiny' (2014) 40(4) *William Mitchell Law Review* 1443, 1446.

violation of the duty of care of directors which aim to prevent them from taking careless decisions.[37] The courts are reluctant to review corporate decisions. The directors and managers usually undertake risky investment projects in managing corporations. If directors were found liable for the loss from a corporate decision on the grounds of negligence, inattention or mismanagement, this would have an undesirable effect on the directors' behaviour and corporate investments, given the scale of the listed companies.[38]

US courts therefore developed the business judgment rule to protect corporate directors from liability for honest mistakes and 'even for judgments that appear to have been clear mistakes – unless certain exceptions apply'.[39] The business judgment rule is 'an acknowledgement of the managerial prerogatives of Delaware directors under Section 141(a)' and a corollary of the rule that 'directors, rather than shareholders, manage the business and affairs of the corporation'.[40] Likewise, In *Smith v. Van Gorkom*, the court indicated that the business judgment rule 'exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors'.[41] So the business judgment rule draws a line between judicial scrutiny and judicial deference to corporate decision-making, and sets the boundaries of the decision-making power of the board.

The business judgment rule presumes that 'in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company'.[42] A shareholder needs to rebut this presumption to make the courts scrutinise corporate decisions. Accordingly, in *Brehm v. Eisner*, the court stated that 'directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that

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[37] See also, Michael Dooley, 'Two Models of Corporate Governance' (1992) 47 *The Business Lawyer* 461, 468 (the duty of care and loyalty address 'two faces of the general problem of opportunism').
[38] *Gagliardi v Trifood* 683 A. 2d 1049, 1052 (Del. 1996).
[39] Robert Clark *Corporate Law* (Aspen 1986) 123.
[40] *Aronson v. Lewis* 473 A.2d 805, 811-2 (Del. 1984).
[41] *Smith v Van Gorkom*, 488 A. 2d 858, 872 (Del. 1985).
[42] *Aronson* (n 40) 812; see also *Brehm v. Eisner,* 746 A.2d 244, 264 (Del. 2000).

includes the failure to consider all material facts reasonably available.'[43] The courts did not establish a systematic list of preconditions of the business judgment rule; therefore, the kind of actions not protected by the business judgment rule vary from judgment to judgment.[44] However, generally, it is built on three assumptions: *i*-directors acted for proper corporate purposes, *ii*- directors were reasonably informed in making their decision and *iii*- directors were disinterested and independent.

As long as corporate decisions can be attributed to a rational business purpose, a decision made in good faith will be provided the protection of the business judgment rule. Even if the decision is substantively wrong, the board will be protected as long as 'the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests'.[45] This judicial concept allows the board to engage in prima facie philanthropic activities or otherwise non-commercial activities. These activities, including donations to universities, corporate strategies aimed at promoting the welfare of employees or the interest of local communities, are accepted as proper purposes for corporations. The classic example of judicial liberalism is the decision in the *Shlensky v. Wrigley* case.[46] The plaintiff, a minority shareholder in the defendant company, sued the defendants because they refused to install lights at a baseball stadium which would enable the team to play at night and generate extra revenues. The court pointed out the potential long-term benefits of only day matches to the local community in increasing the attractiveness of the area near the stadium and refused to review the merits of the decision on the basis of a lack of fraud, illegality or self-dealing.[47]

A plaintiff could demonstrate a failure to act in good faith 'where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the

[43] *Brehm v Eisner* (n 42) n 66.
[44] Clark (n 39) 124.
[45] *Sinclair Oil Corp v Levien*, 280 A.2d 717, 720 (Del 1971) ('To employ a different rule – one that permitted an objective evaluation of the decision- would expose directors to substantive second guessing by ill-equipped judges or juries, which would in the long-run, be injurious to investor interests'.
[46] *Shlensky v. Wrigley*, 95 Ill. App.2d 173 (1968).
[47] *Shlensky v. Wrigley*, 95 Ill. A.2d 173, 181 (Del. 1968) 177.

corporation …'[48] or could prove that the board 'acted in a manner that cannot be attributed to a rational business purpose'.[49] The broad use of corporate discretionary power is subject to judicial scrutiny only if there is wasteful or evidently irrational (which is a way inferring bad faith) use of corporate resources.[50]

Judicial deference extends to almost all kinds of strategic decisions such as entering into a new market, the amount of dividends distributed to shareholders and long-term business strategy. In taking these decisions, the board must have acted in an informed manner,[51] i.e. the board must have exercised reasonable care.[52] When the board fails to act in an informed manner, the business judgment rule does not apply. The requirement of informed judgment is related to the process by which decisions are made rather than the substantial care exercised by the board. The courts describe this as 'process due care'.[53] In *Smith v. Van Gorkom,* the court paid close attention to the board's process and investigated whether the board incorporated all material information reasonably available to itself. The court held that 'the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one'.[54] Thus, a plaintiff must prove that the board acted in a grossly negligent manner in availing themselves of the available information.

In addition, where directors are not disinterested and independent, the business judgment rule does not provide protection. 'A director is interested if he will be materially affected, either to his benefit or detriment, by a decision of the board, in a manner not shared by the corporation and the shareholders.'[55] As regards the lack of independence, a plaintiff would have to demonstrate that a director was sufficiently loyal or beholden to another party to affect the director's ability to judge corporate

[48] *In re Walt Disney Co. Derivative Litigation (Disney II)*, 906 A. 2d 27, 52, 67 (Del. 2006).
[49] *Brehm v Eisner* (n 42) 264 n 66.
[50] Bainbridge (n 30)129.
[51] *Van Gorkom* (n 41).
[52] Bainbridge (n 30).
[53] *Brehm* (n 42) 264.
[54] *Van Gorkom* (n 41) 872.
[55] *Seminaris v Landa*, 662 A. 2d 1350 1354 (Del. 1995).

decision on their merits.[56] In other words, 'the board must be able to act free of personal financial interest and improper extraneous influence'.[57]

The business judgment rule makes it very difficult in practice for courts to review directors' actions. Unless a plaintiff rebuts the presumption, a director will be presumed to be acting on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. In these situations, the board's authority will be respected and protected, and the court will not substitute its own judgment.[58] It is clearly very difficult for a shareholder to overcome the presumptions laid down by the business judgment rule.[59] The importance of the business judgment rule does not lie in the requirement that the presumption must be rebutted by the plaintiff, but rather that the plaintiff cannot win the case by challenging the substantive merits of the decision. In this way, the business judgment rule makes a commitment to protect the substance of a corporate decision.[60] In other words, the court will abstain from examining the substantive merits of decisions unless the plaintiff demonstrates that one or more of the preconditions to the application of the rule are not met.

In specific circumstances, the standard of review for corporate decision-making shifts to enhanced scrutiny and entire fairness.[61] Enhanced scrutiny[62] is the middle tier in terms of the deference to corporate decision-making. It applies 'when the realities of the decision-making context subtly undermine the decisions of even independent and disinterested directors'.[63] Delaware courts first established the enhanced scrutiny for the hostile takeovers in which management resists against the bidder. Generally, enhanced scrutiny applies to the situations which directors are not personally involved in the transaction, but the nature of a transaction could potentially

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[56] *Seminaris v Landa* (n 55) 1354.
[57] *Rales v Blasband* 634 A.2d 927, 935 (Delaware 1993).
[58] *Sinclair Oil Corp v Levien,* 280 A.2d 717, 720 (Del 1971).
[59] Peter Letsou, 'Implications of Shareholder Diversification on Corporate Law and Organization: The Case of the Business Judgment Rule' (2001) 77 *Chicago-Kent Law Review* 179.
[60] Gordon Smith 'The Modern Business Judgment Rule' in Claire Hill and Steven Davidoff (eds) *Research Handbook on Mergers and Acquisition* (Edward Elgar 2016) 83, 86-9.
[61] See, generally Laster (n 36).
[62] The enhanced scrunity test will be examined in detail in the context of hostile takeovers.
[63] *Reis v. Hazelett Strip–Casting Corp* (n 36) 457.

have implications on the directors' motives. Hence, directors are generally required to show that 'their motivations were proper and not selfish' and that 'their actions were reasonable in relation to their legitimate objective'.[64] Courts do not interpret reasonableness narrowly. In other words, they do not seek one single reasonable answer rather 'one of several reasonable alternatives'.[65] In this regard, it still provides substantial deference to corporate decision-making and creates a middle tier standard of review of corporate decision-making.

The standard of review shifts from the business judgment rule to the entire fairness test where the plaintiff rebuts the business judgment rule. [66] 'If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of the fact the 'entire fairness' of the transaction to the shareholder plaintiff'.[67] In other words, if directors are not sufficiently independent, disinterested or informed individuals, the business judgment rule has no application. For instance, where a director appears on both sides of transactions or receives a personal benefit from the transaction not shared by shareholders, directors cannot be regarded as disinterested or independent.[68] In the case of director self-interest in a transaction, entire fairness test is applied. Another example is that where a director is beholden to an interested party to the transaction, entire fairness test is applied instead of the business judgment rule.[69] In this case, directors are required to demonstrate 'the challenged act or transaction was entirely fair to the corporation and its shareholders'.[70] The court usually examines whether the decision was procedurally and substantively fair.[71] Under entire fairness, a substantial deference to the board is attributed because '"perfection is not possible, or expected" as a condition precedent to a judicial determination of entire fairness'.[72] The entire fairness test does not only require the board to act in a procedurally fair manner but also in a substantively fair

[64] *Mercier v. Inter-Tel, Inc*., 929 A. 2d 786, 810 (Del. 2007).
[65] *Paramount Communications v. QVC Network,* 637 A. 2d 34, 45 (Del. 1994).
[66] Laster (n 36) 1455.
[67] *Cede & Co and Cinerama v. Technicolor* 634 A.2d 345, 361 (Del 1994).
[68] *Cede & Co and Cinerama v. Technicolor* (n 67) 362.
[69] *Aronson v. Lewis* (n 40) 815.
[70] *Walt Disney* (n 48) 52; see, *Krasner v. Moffet 826 A.2d 277*, 287 (Del. 2003).
[71] *Cinerama, Inc v Technicolor, Inc.*, 663 A. 2d 1156, 1163 (Del. 1995).
[72] *Cinerama, Inc. v. Technicolor, Inc.,* 663 A. 2d 1156, 1179 (Del. 1995).

manner. In *Cede & Co. v. Technicolor*, the court held that ‘the value of a corporation is not a point on a line, but a range of reasonable values…’. Consequently, when examining the fair price aspect of the test, the court investigates whether ‘a reasonable seller, under all of the circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept’.[73] The procedural and substantive aspects of entire fairness test could be interrelated: ‘a strong record of fair dealing can influence the fair price inquiry, reinforcing the unitary nature of the entire fairness test. The converse is equally true: process can infect price’.[74] Due to the ambiguity which is inevitably embedded in the concept of fairness, it can be concluded that even under the entire fairness test a substantial level of deference is granted to the board's discretion.

There is one more important relevant issue with regards to the business judgment rule. The delegation of authority to the management does not absolve the board from its oversight responsibility. This is not traditionally within the scope of the business judgment rule because the rule applies only where the board exercises business judgment, but the oversight liability arises where the board fails to act.

In re *Caremark International Inc. Derivative Litigation*[75] the court required the directors to demonstrate that they attempted ‘in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists’.[76] The underlying logic behind this decision is that while most issues do not come to the board's attention, the actions of senior or junior employees might have a devastating impact on the company. Therefore, the court requires the board to maintain affirmative legal compliance mechanisms within the company. The court held that the ‘imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations’.[77] In *Stone v. Ritter*, the court reinterpreted the *Caremark* case and stated that:

[73] *Cinerama, Inc. v. Technicolor, Inc.* 663 A. 2d 1134 (Del, 1994).
[74] *Reis v. Hazelett Strip-Casting Corp.,* 28 A. 3d 442 (Del. 2011).
[75] *In re Caremark International Inc. Derivative Litigation* 698 A.2d 959, 969 (Del. Ch. 1996).
[76] *Caremark* (n 75) 970.
[77] *Stone v. Ritter* 911 A.2d 362, 370 (Del. Supr. 2006).

> '… oversight liability draws heavily upon the concept of director failure to act in good faith … In *Disney*, we identified the following examples of conduct that would establish a failure to act in good faith: … where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.'[78]

Relying on a lack of good faith, the court identified the conditions for oversight liability in that: '(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.'[79]

Another oversight case which arose as a result of the financial crisis is in re *Citigroup, Inc. Shareholder Derivative Litigation*.[80] Shareholders on behalf of Citigroup Inc. brought a derivative action to recover losses arising from subprime lending. The shareholders argued that the board breached its fiduciary duty as a result of the failure to monitor and adequately control the business risks in the subprime mortgage market the company had taken and to disclose the risks associated with the subprime lending market. According to the shareholders, there had been clear red flags from early 2005 that should have put the directors on notice of the problems in the real estate and credit markets. Instead, it was argued that the directors decided to approve the business strategy developed by management which entailed taking excessive risks in the subprime mortgage market at the expense of the long-term interests and sustainability of the company, and did almost nothing to avoid these risks.[81] In rejecting the arguments, the court held that in the absence of conflict of interest or disloyalty claims, 'ultimately, the discretion granted directors and managers allows them to maximise shareholder value in the long term by taking risks without the

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[78] *Stone v. Ritter* (n 77).
[79] *Stone v Ritter* (n 77) 369.
[80] *In re Citigroup, Inc. Shareholder Derivative Litigation*, 964 A.2d 106, 139 (Del. Ch. 2009).
[81] See, Todd Aman, 'Cost-Benefit Analysis of the Business Judgment Rule: A Critique in Light of the Financial Meltdown' (2011) 74 *Albany Law Review* 1.

debilitating fear that they will be held personally liable if the company experiences losses',[82] and a judge or jury will be precluded from second-guessing as long as the decisions are the product of a rational and informed decision-making process. Therefore, the substance of corporate decisions is protected from interference. While it seems that directors are subject to oversight liability, it appears that it is difficult to prove their intentional disregard of their oversight responsibilities because the court imposes lax standards of review on directors.

Overall, very strong deference is given to the board where it exercises its powers or fails to act. Carney argues that the business judgment rule is 'a rule of no liability for breaches of the duty of care'.[83] For a long time, directors have been generally aware of the fact that their actions will not be reviewed by the courts on business judgment matters.[84] The aim of the business judgment rule is well articulated by Bainbridge: 'preservation of managerial discretion should always be the null hypothesis.'[85] The court argues that the adverse implications of heavy reliance on the business judgment rule is balanced with shareholder activism and the market for corporate control for shareholders dissatisfied with managerial decisions. In relation to the former factor, it has held that 'if the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out'.[86] With regards to the latter, it states that 'the redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court'.[87] However, in Chapter 2, it was concluded that the market for corporate control does not function as envisaged by theory. The extent to which shareholders can actively engage in the management of a company will be discussed below.

[82] *Citigroup* (n 80) 139.
[83] William Carney, 'The ALI's Corporate Governance Project: The Death of Property Rights?' (1993) 61 *The George Washington Law Review* 898, 922.
[84] Robert Sprague and Aaron Lyttle, 'Shareholder Primacy and the Business Judgment Rule: Arguments for Expanded Shareholder Democracy' (2010) 16 *Stanford Journal of Law, Business and Finance* 1, 16.
[85] Stephen Bainbridge, *Corporation Law and Economics* (Foundation Press 2002), 242.
[86] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A. 2d 946, 959 (Del. 1985); see also *Aronson v. Lewis* (n 40), 811.
[87] *In re Walt Disney* (n 48) 698.

5.3 Shareholders' Governance and Control Rights

This section now moves on to examine shareholders' governance and control rights. The main purpose of this section is to explore the extent to which shareholders could provide accountability in corporate governance as a counterbalance and to consider whether recent regulatory and market developments constitute a considerable shift in the allocation of power between shareholders and directors.

5.3.1 Amendments of Articles of Incorporation or 'Charters' and By-laws

The basic internal structure of corporations is mostly regulated by the articles of incorporation (or charters), by-laws and company law in general.[88] Section 102 of the DGCL states that a charter may include 'any provision creating, defining, limiting and regulating the powers of the corporation, the directors and the shareholders'. The DGCL therefore adopts a flexible and enabling approach in distributing power between the directors and shareholders. The amendment is a two-step process.[89] First, the amendment must be initiated by the board. Second, upon the board's recommendation, it is presented to a shareholder vote. If shareholders that own the majority of shares eligible to vote approve the proposed amendments, then it is adopted. Suppose that Yildiran-Cebi, Inc. has 2,000 voting shares outstanding. At least 1001 affirmative votes are required for the amendment of the charter, regardless of the number of shares present at the annual meeting.[90] The point to note is that shareholders lack the power to initiate charter amendments in the US, while the articles of association could be altered by a special resolution at any time in the UK.[91] In addition, in the UK shareholders holding at least 5% of the total voting rights are entitled to propose changes.[92]

The same voting requirements applicable to charter amendments must be fulfilled to adopt, amend or repeal the by-laws. Section 109 of the DGCL lays down that 'the power to adopt, amend or repeal by-laws shall be in the stockholders entitled

[88] Bainbridge (n 85) 41; bylaws will be examined below.
[89] Section 242(b)(1) of the DCGL.
[90] Bainbridge (n 30) 16.
[91] Section 21 of the Companies Act 2006. Under section 283 of the CA 2006, a special resolution requires three-fourths majority of the votes cast at the meeting.
[92] Section 338 of the CA 2006.

to vote'. Most of the internal governance of the corporation is regulated through by-laws. By-laws mostly deal with issues such as the date of general meetings, procedures for proxy voting, director elections, audit and other internal matters. The role of by-laws was depicted by the Delaware Court of Chancery as follows:

> 'Traditionally, the by-laws have been the corporate instrument used to set forth the rules by which the corporate board conducts its business. To this end, the DGCL is replete with specific provisions authorising the by-laws to establish the procedures through which board and committee action is taken'.[93]

The by-law is in fact 'the only statutory mechanism through which shareholders can bring their will to bear on the governance of a Delaware corporation.'[94] The scope of the by-laws is very broad. Section 109(b) of the DGCL allows corporations to adopt 'any provision, *not inconsistent with law* or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees' (emphasis added).

Under Delaware law, shareholders are given statutory powers to adopt, amend and repeal by-laws.[95] However, the authority to adopt by-laws can be granted to the board of directors through a charter provision.[96] The vast majority of companies in Delaware confer this power upon the board.[97] Since shareholders and directors unilaterally adopt by-laws on a broad range of matters, a large number of private ordering takes place in Delaware in the form of company-specific by-laws.[98] By-laws enable shareholders and directors to customise corporate governance by adopting company-specific rules and terms, which are also known as private orderings.[99]

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93 *Hollinger Intern., Inc. v. Black*, 844 A.2d 1022, 1078-79 (Del.Ch.2004)

94 Christopher Bruner, 'Shareholder Bylaws and The Delaware Corporation' (2009) 11 *The Tennessee Journal of Business Law* 67, 69.

95 Section 109 of the DGCL.

96 Section 109(a) of the DGCL.

97 Ann Lipton, 'Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws' (2016) 104 *Georgetown Law Journal* 583, 589 n 25.

98 See Fisch (n 101).

99 Gordon Smith, Matthew Wright and Marcus Hintze 'Private Ordering with Shareholder Bylaws' (2011) 80 *Fordham Law Review* 125, 127 n 12.

Similarly, Strine stated that in *Boilermakers Local 154 Retirement Fund v. Chevron Corporation* that 'the by-laws of a Delaware corporation constitute part of a binding broader contract among the directors, officers and stockholders formed within the statutory framework of the DGCL'.[100]

By-laws have been increasingly used by shareholders with Fisch describing this trend as the 'New Governance'[101] in which shareholders actively shape corporate governance. The use of private orderings has not been unilateral with boards responding through different mechanisms to limit shareholders' power or impose procedural or higher requirements to the exercise of shareholder rights.[102] By-laws became one of the key battlegrounds between the board, management and shareholders. The courts, unfortunately, developed divergent treatment of shareholder-adopted by-laws (such as the reimbursement by-laws[103]) and board-adopted by-laws (such as exclusive forum selection by-laws[104] and fee-shifting by-laws[105]). Shareholders' power to adopt, amend and repeal by-laws is more restricted than the board's power.

Courts provided larger room for board-adopted by-laws, despite the fact that section 109 regulates permissible by-laws for both directors and shareholders. It seems possible that directors devise very creative and innovative by-laws that could in practice effectively prevent shareholders from exercising their rights. The most recent example of governance innovations is litigation by-laws such as exclusive forum by-laws, fee-shifting by-laws, and arbitration by-laws.[106] These litigation by-laws arguably seek to address concerns regarding frequency of shareholder litigation. In *Boilermakers v. Chevron,* the board adopted an exclusive forum selection by-law for

[100] *Boilermakers Local 154 Retirement Fund v Chevron Corporation* 73 A. 3d 934 (Del. 2013).
[101] Jill Fisch, 'The New Governance and the Challenge of Litigation Bylaws' (2016) 81 *Brooklyn Law Review* 1637.
[102] Fisch (n 101)1638.
[103] *CA, Inc. v. AFSCME Emp. Pension Plan,* 953 A. 2d 227, 229 (Del. 2008) (the court found the reimbursement bylaw regarding director elections invalid).
[104] *Boilermakers Local 154 Ret. Fund v. Chevron*, 73 A. 3d 934 (Del. 2013) (the court found the exclusive forum selection bylaw valid).
[105] *ATP Tours, Inc. v. Deutscher Tennis Bund,* 91 A. 3d 554 (Del. 2014) (the court found the fee-shifting bylaw valid).
[106] Fisch (n 101) 1665.

disputes arising from the internal affairs of the defendant company.[107] This type of by-law is a response to multi-forum litigation by shareholders. In upholding the by-law, the court held that the board is granted power to adopt such by-laws under section 109 of the DGCL. In rejecting shareholders' argument that the board acted unilaterally, the court stated that shareholders 'will be bound by by-laws adopted unilaterally by their boards'[108] and highlighted that 'stockholders have powerful rights they can use to protect themselves if they do not want board-adopted forum selection by-laws to be part of the contract between themselves and the corporation'.[109] This further encouraged directors to engage in similar private ordering through by-laws.

The second type of by-laws concerns fee-shifting by-laws. In *ATP Tour v. Deutscher Tennis Bund*, the court upheld a board-adopted by-law that required shareholders to pay directors' attorney fees unless shareholders received their claim from directors in its entirety.[110] In other words, 'if plaintiffs claimed $50 million in damages, for instance, but only obtained $40 million they would be responsible for paying the defendants' fees, despite the obvious success of the litigation'.[111] It is highly unlikely that a plaintiff could achieve this level of success. The fee-shifting by-law gives rise to a central concern about the risk that directors could also restrict shareholders' ability to bring a lawsuit against the board and management. In upholding the by-law, the court underscored the contractual nature of by-laws and stated that there is nothing preventing directors from adopting a fee-shifting by-law because corporate litigation is related to the business of the corporation under section 109.[112] The final type of litigation by-laws are mandatory arbitration bylaws. Following cases like *Boilermakers v. Chevron*, *ATP Tour v. Deutscher Tennis Bund* and *AT&T Mobility L.L.C. v. Concepcion*,[113] scholars began to speculate that there is no remaining legal barrier which prevents directors from unilaterally adopting

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[107] *Boilermakers v Chevron* (n 100).
[108] *Boilermakers v Chevron* (n 100) 956.
[109] *Boilermakers v Chevron* (n 100) 956.
[110] *ATP Tour v Deutscher Tennis Bund* 91 A. 3d 554, 556 (Del. 2014).
[111] David Skeel, 'The Bylaw Puzzle in Delaware Corporate Law' (2016) 72 *The Business Lawyer* 2, 12 fn 67.
[112] *ATP Tour v Deutscher Tennis Bund* (n 110) 558.
[113] *AT&T Mobility L.L.C. v. Concepcion* 131 S.Ct. 1740 (2011).

mandatory arbitration with class action waivers.[114] These director-adopted by-laws demonstrate how broadly director by-laws are interpreted under section 109. These by-laws could effectively prohibit shareholders from initiating suits to protect their rights which means that directors can shield themselves from accountability.

The court, however, found a shareholder-adopted reimbursement by-law invalid in *CA v. AFSCME*.[115] It discussed this issue and restricted shareholders' power to adopt, amend and repeal by-laws. AFSCME, a union pension fund, sought to submit a shareholder amendment to rules governing the reimbursement of reasonable expenses incurred in the course of directors' elections. The board sought to exclude this amendment from the proxy statements of the company.[116] Thereafter, the SEC asked the Delaware Supreme Court whether such an amendment was a proper subject for shareholder action and whether it would cause the board to violate any Delaware law before issuing a no-action letter.

The court, in response, developed a two-prong test: a- whether the by-law is within the scope of shareholders' by-law power and b- whether the by-law impermissibly intrudes on the board's discretionary power under section 141(a). With regard to the former question, the court found the by-law permissible under Delaware law. However, the court issued critical guiding principles of the scope of shareholder power to adopt by-laws, and the scope of permissible by-laws. Perhaps the most important guiding principle is that 'the shareholders' statutory power to adopt, amend or repeal by-laws is not coextensive with the board's concurrent power and is limited by the board's management prerogatives under Section 141(a)'.[117] Director primacy lies at the heart of the reasoning of this principle. The court then went on to analyse the proper function of by-laws and stated that it is 'not to mandate how the board should decide specific substantive business decisions, but rather, to define the process

[114] David Webber, 'Shareholder Litigation without Class Actions' (2015) 57(1) *Arizona Law Review* 203; Claudia Allen, 'Bylaws Mandating Arbitration of Stockholder Disputes?' (2015) 39 *Delaware Journal of Corporate Law* 752.
[115] *CA, Inc. v. AFSCME*, 953 A.2d 227, 229–30 (Del. 2008).
[116] Shareholder proposals will be discussed below. However, a brief note is necessary here. Under Rule 14a-8, the board of directors could refuse to distribute shareholder proposals to other shareholders through the company's proxy mechanism.
[117] CA (n 115) 232 n.6.

and procedures by which those decisions are made'.[118] Such a limitation is problematic because section 109 does not provide any legal ground for exclusively procedural by-laws. Section 109(b) deliberately employs the term 'any provision' and provides that a by-law can be related to 'the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees'. As such, the permissibility of by-laws depends on what the court understands by the abstruse terms 'procedural' and 'substantive'. On the basis that the reimbursement proposal aims to facilitate directors' elections, the by-law was found to be 'process related', i.e. a proper subject for shareholder action.

The court then moved on to analyse whether the proposed by-law would impermissibly intrude on the board's discretionary authority, i.e. such a by-law would cause the board of directors to violate their fiduciary duties. It found that the by-law was inconsistent with the law, and held that:

> 'the internal governance contract—which here takes the form of a by-law—is one that would also prevent the directors from exercising their full managerial power in circumstances where their fiduciary duties would otherwise require them to deny reimbursement to a dissident slate'.[119]

It is hard to find this argument persuasive because such an understanding could deter all kinds of by-laws. Virtually all by-laws interfere with the board's power to a certain extent and one may always come up with an interpretation that the board is forced to act in a certain way that violates its fiduciary duties.[120] Earlier in the same judgment the court itself reasoned that:

> 'By-laws, by their very nature, set down rules and procedures that bind a corporation's board and its shareholders. In that sense, most, if not all, by-laws could be said to limit the otherwise unlimited discretionary power of the board'.[121]

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[118] CA (n 115) 234-5.

[119] CA (n 115) 239; The opposite result in this case was reached in *Hollinger International, Inc. v. Black*, 844 A.2d 1022, 1080 (citing *Frantz Manufacturing Co. v. EAC Industries*, 501 A.2d 401 (Del. 1985) 'the Delaware Supreme Court made clear that bylaws could impose severe requirements on the conduct of a board without running afoul of the DGCL').

[120] Brett McDonnell 'Bylaw Reforms for Delaware 's Corporation Law' (2008) 33 *Delaware Journal of Corporate Law* 651, 664.

[121] *CA* (n 115) 234.

Even a by-law for the removal of a defensive mechanism could be interpreted within the scope of the decision. In 1997, Coffee made a similar comment: 'on this basis, attempts to restrict defensive tactics arguably interfere with the board's choice of the optimal "time frame for achievement of corporate goals"'.[122] It is difficult to determine what kind of by-laws would really force the board to act in a way that violated its fiduciary duties or would prevent directors from managing and directing the business and affairs of a company under Section 141(a). In short, the court held that while a reimbursement proposal is a proper subject for shareholder action under Section 109, it was invalid because it might require the board to act in a way which prevents directors from discharging their fiduciary duties.

The analysis in *CA v. AFSCME* shows that shareholders' power to adopt by-laws is controversial and more limited. While the court found the board-adopted by-laws permissible under section 109(b), it did not consider shareholder-adopted by-laws valid under the same section. The challenge is to explain the court's divergent treatment of by-laws, i.e. why one set of by-laws is permissible, but another is not. There must be something that makes shareholder reimbursement by-laws less appropriate than exclusive forum selection or fee-shifting by-laws.

The reason behind the divergent treatment of by-laws appears to lie in the different proponents of by-laws. This distinction, however, does not arise from section 109 but from the confusion between section 109(b) and 141(a), and the court's strong commitment to near-absolute director primacy. The wording of sections 109(b) and 141(a) causes considerable confusion. Gordon described this situation as a 'recursive loop':[123] The shareholders' power to alter and adopt a by-law is restricted by the law, including the authority of the board, while the board's authority to manage the company under section 141(a) is limited to provisions in the DGCL including the shareholders' by-laws.[124] Moreover, depending on the interpretation of section 141(a), this may substantially limit the scope of by-laws. This has further implications for

[122] John Coffee, 'The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?' (1997) 51 *University of Miami Law Review* 605, 613.
[123] Jeffrey Gordon, 'Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett,' (1997) 19 *Cardozo Law Review* 511, 551.
[124] See also, Gordon Smith et al., 'Private Ordering with Shareholder Bylaws' (2011) 80 *Fordham Law Review* 125, 141.

shareholders' proposals. As will be discussed in detail below, this conflict is often used by the management to exclude shareholders' proposals from the company's proxy materials. This constitutes a practical impediment to shareholder activism because shareholder resolutions regarding by-law changes are generally presented under Rule 14a-8. Shareholders could prefer an independent proxy solicitation for the by-law amendments, but as discussed in Chapter 4, the independent proxy campaigns are prohibitively expensive for mainstream institutional investors. Only large funds and activist funds could bear the cost of independent proxy campaigns. Therefore, the recursive loop constitutes a further limitation on shareholder by-laws and increases the cost of activism.

The Delaware General Assembly subsequently adopted several amendments after the controversy arising from the by-law litigation. Section 113 permits companies to adopt by-laws that reimburse the expenses of shareholders incurred in the course of proxy contests. These reactions are clearly a response to concerns about the accountability and responsiveness of the board and accordingly to the call for increased shareholder voice. Section 112 allows shareholders to adopt private ordering which grants shareholder access to proxy solicitation materials in order to nominate directorial candidates. In response to the fee-shifting by-laws and forum selection by-laws, the Delaware legislature made amendments to sections 102(f) and 109(b), which now prevent a company from adopting a fee-shifting by-law or charter provision. Section 115 now permits a company to select Delaware courts as an exclusive forum, but prohibits exclusive forum provisions that prevents parties from bringing a lawsuit in Delaware. Yet it appears that the courts' tendency to give weight to section 141(a) and to interpret section 109 more narrowly than section 141 has survived and will remain both an obstacle to shareholder activism and an aid to the board in excluding shareholder proposals.

An additional concern also arises from the fact that both the shareholders and directors hold the authority to adopt by-laws. It is not clear whether the board could repeal or amend shareholder-adopted by-laws under Section 141(a). There is a further ambiguity regarding whether shareholders can make the by-laws immune from directors' intervention.[125] The Delaware Supreme Court stated in dictum that a by-law which is designed not to be amended by directors would be in conflict with the directors' authority to adopt, amend and repeal by-laws; therefore, such by-laws would be void.[126] The court upheld the removal of a critical by-law, despite shareholders' evident opposition to the by-law's repeal.[127] The court's reasoning was that shareholders could adopt the by-law again or remove directors in the next election. Similarly, in *General Datacomm Inc., v. Wisconsin Investment Board,* Strine observed that the interpretation that the board could repeal shareholder-adopted by-laws might be the correct one.[128] In short, there is further legal uncertainty whether directors' authority extends to shareholder-adopted by-laws and whether a shareholder-adopted by-law could prevent the board from repealing or amending it.

In conclusion, shareholders' authority to adopt, amend and repeal by-laws is more limited than the board's authority because of the judicial deference to the board. Delaware courts have given a broad scope to board-adopted by-laws. These by-laws could be self-interested and, more importantly, could restrict shareholder rights or the exercise of shareholder rights. The recursive loop between sections 109(b) and 141(a), and the immediate embracement of director primacy as a matter of case law have led the courts to narrowly interpret section 109(b) to prevent shareholders from adopting by-laws. The limitations on shareholder power does not arise from the law itself but from the courts' decisions through their divergent treatments of board- and shareholder-adopted by-laws.

5.3.2 Proxy Rules and Securities Exchange Act Rule 14a-8

It is well known that many shareholders in large companies do not show up personally to general meetings. These shareholders usually exercise voting rights through the proxy access system. For public companies, the proxy process is regulated by federal

[125] *General Datacomm Industries, Inc v. State of Wisconsin Investment Board* 731 A.2d 818, 821 n.2 (Del. Ch. 1999).
[126] *Centaur Partners, IV v. National Intergroup, Inc.*, 582 A. 2d 923, 929 (Del. 1990).
[127] *American Int'l Rent-A-Car, Inc v Cross,* 1984 Del. Ch. LEXIS 413 (Del. 1984) cited in Jill Fisch, 'Governance by Contract: The Implications for Corporate Bylaws' (2017) *ECGI Law Working Paper* 350/2017.
[128] *General Datacomm Industries* (n 126) 821 n 1.

law.[129] Federal regulations lay down criteria concerning whether shareholders are eligible to submit proposals and whether the contents of the proposals are permissible in Rule 14a-8 of the Securities Exchange Act[130] among other things. The Rule 'in its fundamental aspects is not an invention of the SEC. It is an almost necessary consequence of the status of the individual shareholder under the laws of various states of incorporation …[The rule] is merely a recognition of rights granted by state law.'[131] The aim of proxy regulation is to 'improve [proxy] communications and thereby to enable proxy voters to control the corporation as effectively as they might have by attending a shareholder meeting'.[132] Put differently, the aim of proxy rules is to breathe life into state-based shareholder rights.

Shareholders have long been denied access to company's proxy statements, even though shareholders who are present at the general meeting can nominate directors or submit proposals from the floor of the meeting under state law.[133] While Berle described a shareholder meeting as a 'kind of ancient, meaningless ritual like some of the ceremonies that go with the mace in the House of Lords',[134] shareholders are no longer as passive as was the case in the past and now show an interest in board and governance related proposals. Rule 14a-8 has become more important than ever.

Companies are required to have at least one shareholder meeting a year under section 211 of the DGCL at which directors are elected and other related issues are decided. The value of voting rights not only depends on the matters shareholders are allowed to vote on but also how smoothly they can add new items to the agenda of general meetings. The SEC has enacted Rule 14a-8 to 'catalyse what many hoped would be functional "corporate democracy"'.[135] It does not allow all shareholder

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[129] 17 CFR 240.14a-1 to 14b-2.
[130] 17 CFR 240.14a-8.
[131] Milton Freeman, 'An Estimate of the Practical Consequences of the Stockholder's Proposal Rule' (1957) 34 *University of Detroit Law Journal* 549, 550.
[132] *Business Roundtable v. SEC*, 905 F. 2d 406, 411 (D.C. Cir. 1990).
[133] Robert Brown, 'The Proxy Rules and Restrictions on Shareholder Voting Rights' (2016) 47 *Seton Hall Law Review* 45, 47.
[134] Adolf Berle, *Economic Power and The Free Society* (University Microfilms 1971) 7.
[135] Alan Palmiter, 'The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation' (1994) 45 *Alabama Law Review* 879.

proposals to be included in the proxy materials of a company at the company's expense. Instead it imposes procedural and substantive eligibility requirements.

Rule 14a- 8 provides important substantive grounds for the exclusion of proposals from the company's proxy statements. Historically, the earliest version of the rule contained only one substantive ground for exclusion[136] which was that a shareholder proposal must be 'a proper subject for action by the security holders'.[137] The number of exclusion grounds increased to thirteen. These additional restrictions primarily sought to reduce the number of shareholder proposals and to limit shareholder access to Rule 14a-8.[138] Despite the limitations, however, proposals became a key corporate governance tool due to increased shareholder activism. Shareholders usually prefer to submit proposals under Rule 14a-8.

The procedural constraints are that the proponent must have shares worth at least \$2000 or 1% of the company's voting shares, whichever is the lesser, and must hold the shares for at least one year before submitting the proposal.[139] The proposal must be received 120 days before the shareholder meeting. As regards the substantive constraints, the SEC allows companies to exclude proposals from the proxy materials of companies on different grounds. Moreover, the rule provides management with thirteen substantive grounds on which to exclude proposals from the company's proxy materials. These grounds are: 1- *improper under state law*, 2- *violation of law*, 3- *violation of proxy rules* 4- *personal grievance or special interest*, 5- *relevance*, 6- *absence of power/authority*, 7- *management functions*, 8- *relates to election*, 9- *conflicts with company's proposal*, 10- *substantially implemented*, 11- *duplication*, 12- *resubmissions*, and 13- *specific amount of dividends*.[140] If a company wishes to omit a shareholder proposal on one or more of these grounds, the company submits its

[136] Lisa Fairfax, *Shareholder Democracy* (Carolina Academic Press, 2011) 66.
[137] SEC, Solicitation of Proxies under the Act, Exhange Act Release No. 34-3347, 7 Fed. Reg. 10,655, 10,656 (22 Dec 1942).
[138] Jill Fisch, 'From Legitimacy to Logic: Reconstructing Proxy Regulation' (1993) 46 *Vanderbilt Law Review* 1129, 1149.
[139] 17 C.F.R. § 240.14a-8(b).
[140] 17 C.F.R. § 240.14a-8(i)(1-13).

reasons for omitting the proposal to the SEC and shareholders.[141] Almost every company seeking to omit a proposal demands a no-action letter[142] from the SEC.[143]

Companies often use more than one ground in justifying their exclusion. It is impossible to examine all of them here, but a number of grounds can be listed to stress the wide-ranging power that the management has to exclude proposals. As it appears, the rule provides very broad discretion to the board to exclude shareholder proposals from the proxy material of the company, and moreover prevent shareholders from expressing their voice. Historically, conflicts with state law, the ordinary business exclusion, relevance, and elections have been primarily used by companies as their primary reasons.[144] Other than directors' elections, these exclusion grounds are merit-based exclusions, that are primarily used by the board and management. Among them, the most frequently used ground by companies is the ordinary business exclusion.[145] These exclusion grounds make shareholders design their proposals in a precatory rather than binding form.[146] Otherwise, shareholders' proposals could be excluded by the board on the grounds of improper subject under state law, i.e. an intrusion on the board's authority under section 141(a). The other exclusion grounds basically eliminate vexatious, illegal, deceptive and frivolous proposals.

The first important exclusion ground is that the proposal 'conflicts with state or other law'.[147] The aim of this basis for this exclusion is to respect the states' law regarding the allocation of power between shareholders and directors, and other related issues.[148] As seen above and in the courts' profound understanding of director primacy theory, this exclusion ground leaves only a limited capacity for shareholder

[141] 17 C.F.R. § 240.14a-8(g).
[142] 'A no-action letter is one in which an authorised staff official indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated.' SEC, Procedures Utilized by The Division of Corporation Finance For Rendering Informal Advice, Securities Act Release No. 6253 (28 October 1980).
[143] See Donna Nagy, 'Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework' (1998) 83 *Cornell Law Review* 921, 939.
[144] Fairfax (136) 70.
[145] Reilly Steel, 'The Underground Rulification of the Ordinary Business Operations Exclusion' (2016) 116 *Columbia Law Review* 1547, 1548.
[146] Friedman (n 24) 51.
[147] 17 CFR 240.14a-8(i)(1)-(2).
[148] Robert Clark, *Corporate Law* (Aspen 1986) 372.

proposals under Rule 14a-8. A proposal that mandates an action or directs the board would be improper under Rule 14a-8(i)(1). This also accounts for why most shareholders frame their proposals in a non-binding form rather than a binding fashion.[149] If such a proposal passes, directors are not required to implement it. These non-binding shareholder proposals, therefore, are mainly regarded as a communication method between shareholders and the board rather than effective governance tools.[150] As discussed above, a by-law regarding a specific business decision is probably invalid. However, it is not clear whether by-laws that impose constraints rather than require the board to take action are permissible or not under Delaware law.

The second exclusion ground is the ordinary business exclusion.[151] Most shareholder proposals are excluded on the grounds of ordinary business exclusion; therefore, it is the most litigated and debated exclusion ground. The SEC often struggles to draw the dividing line between ordinary business matters and others because of the design of the exclusion ground as an open-ended standard. This exclusion was originally promulgated to maintain the distinction between the board and shareholders under state law but extended to proposals that were designed in non-binding form.[152] This exclusion ground has been revised several times. [153] The major revision to the exclusion ground came in 1998 when a change was made to the interpretation of the rule. The SEC issued a sweeping no-action letter in the *Cracker Barrel* case discussed in Chapter 3. This no-action letter created a bright-line test for excluding all proposals relating to employment matters. With far-reaching implications for the public, the SEC returned to its earlier case-by-case examination and developed a two-prong test to decide whether a proposal can be excluded.[154] The

[149] Friedman (n 24) 51.
[150] Fisch (n 181) 479.
[151] Ordinary business matters refers to the matters that are 'so fundamental to management's ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight'. See SEC, Amendments to Rules on Shareholder Proposals, Exchange Act Release No: 34-40018 63 Fed. Reg. 29,106, 29108 (28 May 1998).
[152] Steel (n 145) 1559.
[153] SEC, Solicitation of Proxies, 19 Fed. Reg. 246, 247 (14 January 1954); SEC, Adoption of Amendments Relating to Proposals by Security Holders, Exchange Act Release No:34-12,999, 41 Fed. Reg. 52,994, 52,998 (3 December 1976); See Donald Schwartz, 'The Public Interest Proxy Contest: Reflections on Campaign GM' (1971) 69 *Michigan Law Review* 419, 421-3.
[154] Sec (n 151) 29,108.

first prong is related to the subject matter of the proposal. If the proposal is related to ordinary business matters, then it is in principle excludable, unless it raises significant social policy issues. Proposals relating to such matters but raising significant policy issues would transcend day-to-day business matters and would be appropriate for a shareholder vote. The second prong relates to where a proposal 'seeks to ''micro-manage'' the company by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgement'. In such circumstances, the proposal is excludable regardless of the significance of any social matters.[155] Despite the fact that this exception is not applied to proposals involving the important issues of public policy that transcend the ordinary business of companies,[156] the SEC has been ambiguous and inconsistent in the application of the exclusion in the absence of meaningful and objective standards. Proposals treated as subject to exclusion on the ground of ordinary business matters have become includable as having significant public policy implications and vice versa.[157]

The exclusion grounds continue to create controversy. For instance, the SEC issued a no-action letter for a shareholder proposal that asked the board to revise the company's policy regarding the use of antibiotic medicines in feeding animals, which is detrimental to public health according to shareholders.[158] However, upon reconsideration of the no-action letter, the SEC concluded that it is 'unable to concur in Tyson's view that it may exclude the proposals under rule 14a-8(i)(7)'.[159] A recent example is *Trinity Wall Street v. Wal-Mart Stores, Inc*.[160] The case was related to a proposal that asked directors to develop and implement standards for the sale of high-

[155] Sec (n 151) 29,108.
[156] SEC, Adoption of Amendments Relating to Proposals by Security Holders, 41 Fed. Reg. 52,994, 52,998 (3 December 1976).
[157] See Palmiter (n 135) 906; See also Adrien Anderson, 'The Policy of Determining Significant Policy under Rule 14a-8(i)(7)' (2016) 93 *Denver Law Review* 183, 192-7.
[158] SEC, No Action Letter regarding Tyson Food, (10 November 2009) < https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2009/humanesociety111009-14a8.pdf > accessed 03 June 2017.
[159] SEC, No Action Letter regarding Tyson Food (15 December 2009) < https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2009/trinityhealth121509recon-14a8.pdf > accessed 03 June 2017.
[160] *Trinity Wall Street v. Wal-Mart Stores, Inc* 958 F. 3d 323 (3d Cir. 2015).

capacity firearms. The board obtained the no-action letter under Rule 14a-8(i)(7). Shareholders challenged the no-action letter and the trial court held that the proposal did not fall within the scope of ordinary business matters because the proposal raised significant policy issues which should be subject to a shareholder vote.[161] However, on appeal the Court of Appeal reversed the decision and held that the proposal was excludable under Rule 14a-8(i)(7) because although the proposal was related to significant policy issues, these matters did not transcend the ordinary business matters of the company.[162] The court adopted a more stringent approach than the SEC and required that a shareholder proposal must raise a significant policy issue and must transcend the company's ordinary business.[163] This new analytical understanding could be too restrictive for shareholders. The SEC's traditional approach is broader than the new analytical understanding because the proposals raising a significant policy issue would transcend the ordinary business matters of companies.[164] Similarly, Judge Schwartz argued that the proposal 'lacks the focus needed to trigger the "significant social policy" exception'.[165] Three different perspectives, viz. the SEC's/Judge Schwartz's opinion, the district court's opinion, and the court of appeal's opinion emerged from the same dispute. This presents a noteworthy example of the inconsistent and ambiguous application of the rule. In short, the rule is in state of disarray.

The third exclusion ground is 'relevance' which is designed to address proposals considered irrelevant to the company's business.[166] It is again a vague rule and does not provide clear guidance. The initial version of this exclusion sought to bar social proposals promoting 'economic, political, racial, religious or social causes'.[167] For instance, the shareholder proposal which was submitted to abolish segregation on Greyhound buses in 1952 was excluded and the SEC approved the exclusion on the

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[161] *Trinity Wall* Street v. Wal-Mart Stores, Inc., 75 F. Supp. 3d 617, 630-1 (D. Del. 2014).
[162] *Trinity Wall Street v. Wal-Mart Stores* (n 160).
[163] *Trinity Wall Street v. Wal-Mart Stores* (n 160) 347.
[164] SEC (n 151) 29,108.
[165] *Trinity Wall Street v. Wal-Mart Stores* (n 160) 354.
[166] Robert Brown, 'The Evolving Role of Rule 14a-8 in the Corporate Governance Process' (2016) 93 *Denver Law Review Online* 151, 164.
[167] Fairfax (n 136) 74.

grounds of a lack of relevance, owing to the proposal's 'general political, social, and economic nature'.[168] However, the SEC recognised that there might be some social issues relevant to a company's business and amended the exclusion. Rule 14a-8(i)(5) lays down that a proposal relating to operations accounting for less than 5% of the company's assets, earnings and sales, and that is not 'otherwise significantly related to the company's business' may be omitted from the company's proxy materials. The vagueness of this rule has led to unclear and inconsistent decisions by the SEC and allowed companies to exclude shareholder proposals even if they raise concerns regarding forced labour, human embryonic stem cell research or other similar issues.[169] This exclusion ground is very similar to the ordinary business exclusion ground because where a shareholder submits an economically-orientated proposal falling short of 5% of the company's assets, the outcome of the proposal would likely be immaterial for the company and would fall within the scope of the ordinary business exclusion. As regards the non-economic aspects of the exclusion ground, it is not clear how the SEC or judges decide whether a shareholder proposal has sufficient ethical or social significance to justify the inclusion of the proposal in the company's proxy statements. In the end, the rule was aimed at excluding shareholder proposals promoting general economic, social, racial and political causes. So the exclusion could possibly be interpreted very broadly to the extent that it leaves very little scope for shareholder proposals relating to social concerns. The final restriction concerns the directors' elections. Since it is examined in detail in the section on directors' elections, it will not be covered here.

Such restrictions make it difficult for shareholders to present an alternative view to the board and other shareholders which might, if presented, contribute to the sustainability of the company. Shareholder activism could serve companies in addressing managerial inefficiencies and increasing the immediate performance of companies as well as in gaining social legitimacy. The importance of Rule 14a-8 was not recognised until after the 1990s, specifically, after the Enron failure.[170] There was

[168] Charles Bane, 'Shareholder Proposals on Public Issues' (1971) *The Business Lawyer* 1019.
[169] Kathy Kaoudis, 'Sec Rule 14a-8(i)(5): Is It Still Relevant?' 93 *Denver Law Review Online* 251, 259-60.
[170] Paul Rose, 'A Proposal to Rescind the Shareholder Proposal Rule' (2014) 66 *Florida Law Review* 2179, 2201.

a noticeable increase in the number of ordinary and contested proposals and in the support for these proposals.[171] Nowadays, the majority of shareholders usually support governance related or firm-specific proposals.[172] In line with increasing shareholder support, board responsiveness to shareholder proposals has also increased.[173] The agenda of shareholder proposals has evolved from social and environmental issues to board and governance issues since the Enron collapse.[174] These proposals mostly target underperforming companies or companies with poor corporate governance structures but there is no strong evidence of systemic agenda controlling.[175] The increasing use of shareholder proposals leads to a decrease in the number of staggered boards, anti-takeover mechanisms and plurality voting, and the separation of chairman and CEO positions. These kinds of proposals are not to disrupt the board's authority but to draw their attention to governance or other related matters. The exclusion grounds, therefore, lead to an unnecessary waste of resources and time. Since shareholder activism aims to produce changes to the way in which the company is run, the broad interpretation of rules undermines the value of shareholder activism.

5.3.3 Appointment of Directors

In the US, the legitimacy of directorial power depends on the shareholders' power to elect directors.[176] The underlying logic is simple: if shareholders are dissatisfied with the board and management, they can theoretically replace the board and management in the next shareholders' meeting. The board's election is a mechanism to ensure that directors are well-equipped and skilled for the position and to monitor poorly performing management.[177] The possibility of replacement incentivises the board of

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[171] Bonnie Buchanan and et al., 'Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom' (2012) 49 *American Business Law Journal* 739, 763-5.
[172] Randall Thomas and James Cotter, 'Shareholder Proposals in the New Millennium: Shareholder Support, Board Response and Market Reaction (2007) 13 *Journal of Corporate Finance* 368.
[173] Yonca Ertimur et al., 'Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals' (2010) 16(1) *Journal of Corporate Finance* 53.
[174] Fairfax (n 136) 78.
[175] Luc Renneboog and Peter Szilagyi, 'The Role of Shareholder Proposals in Corporate Governance,' (2011) 17 *Journal of Corporate Finance* 167, 177.
[176] *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).
[177] *Hoschett v. TSI Intern. Software, Ltd.*, 683 A. 2d 43, 45 (Del 1996); See also Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991) 70-2.

directors to perform better and to reduce agency costs in listed companies.[178] Even if an attempt to replace the board is unsuccessful, it may still create discernible positive outcomes such as incentivising the management to focus on shareholder value and to reveal the shortcomings in the governance of the company. Succinctly, the right to nominate and appoint directors, i.e. a competitive board election, is a means of bringing discipline to the board of directors[179] and management.

In the US, directors' elections are regulated at the federal and state law levels. Under federal law, the board is granted the power to exclude shareholder proposals from the company's proxy cards on a range and number of issues.[180] However, the substance of the right to nominate is regulated under state law. Since many shareholders do not attend meetings in person in the case of public companies, proxy access is as important as the substance of the voting right. It is therefore necessary to examine the appointment and nomination rights at these two levels.

An historical examination of the nomination power of shareholders will show how weak shareholders were and how they started to gain power gradually over the last decade, in particular after the 2007-2008 financial crisis. A combination of state and federal laws restrict shareholders' power to nominate or choose nominees.[181] Increased shareholder activism and the financial crisis generated significant momentum for relatively shareholder friendly director elections in the US.

5.3.3.1 Shareholder Proxy Access in the context of Director Elections

The former SEC chairman Arthur Levitt famously said in 2006 that 'a director has a better chance of being struck by lightning than losing an election'.[182] In 2011, only 26 out of 16,822 candidates (0.15%) in the 3000 largest public companies were

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[178] Lucian a Bebchuk, 'The Myth of the Shareholder Franchise' (2007) 93 *Virgina Law Review* 675, 679.

[179] See Lucian Bebchuk, 'The Case for Shareholder Access to the Ballot' (2003) 59(1) *The Business Lawyer* 43.

[180] This will be discussed below.

[181] See also William Klein, Mark Ramseyer, and Stephen Bainbridge *Business Associations Agency, Partnerships, and Corporations* (Foundation Press 2012) 549; Robert Clark *Corporate Law* (Aspen 1986) 360; Jill Fisch, 'The Destructive Ambiguity of Federal Proxy Access' (2012) 61 *Emory Law Journal* 435.

[182] Arthur Levitt, 'Stocks Populi' *The Wall Street journal* (27 October 2006) < http://www.wsj.com/articles/SB116191410503505582> accessed 25 September 2016.

nominated by shareholders.[183] Directors are often faced with a low probability of replacement by shareholders. While some argued that shareholders had enough power under existing rules,[184] the evidence from directors' elections above, the statement of the chairman of the SEC, and the costs of running an independent proxy contest (which can be around $2.5 million)[185] challenge this view.

The proxy access of shareholders has also been restricted but it has always been the subject of reform by the SEC.[186] Under Rule 14a-8, the board had discretion to exclude shareholder-nominated candidates from the corporate ballot for a long time. Only the names and information about management nominees are sent to shareholders through a company's proxy statement and the board can exclude the shareholders' nominees from the company's proxy statements. As such, it becomes mostly a foregone conclusion that shareholders do not play any role, other than voting for the candidates nominated by management. Eisenberg stated that 'to give any group exclusive access to the corporate proxy materials for the purpose of designating its directorial candidates would be virtually tantamount to giving that group the power to elect the board'.[187] This significantly diminishes the impact of the threat, which is a considerably important tool in shareholder activism. It also constitutes a dilemma since the judgments of courts in the case of the business judgment rule have argued that if shareholders are unhappy with management, they should elect new directors. However, without having any chance to nominate directors, shareholders are mostly left with the incumbent board's candidates. Therefore, the court's reasoning does not function properly in practice.

Contested elections, furthermore, play a key role in the determination of the future business strategies of companies. The incumbent directors and top managers therefore make significant efforts to maintain their positions and, conversely,

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[183] Bo Becker and Guhan Subramanian, 'Improving Director Elections' (2013) 3 *Harvard Business Law Review* 1, 2.
[184] SEC 'Letter from Wachtell, Lipton, Rosen & Katz to Jonathan' (June 11,2003) < https://www.sec.gov/rules/other/s71003/wachtell061103.htm > accessed 02 October 2016.
[185] Bebchuk (n 178) 689.
[186] Lisa Fairfax, 'The Future of Shareholder Democracy' (2009) 84 *Indiana Law Journal* 1259, 1260-1.
[187] Melvin Eisenberg, 'Access to the Corporate Proxy Machinery' (1970) 83(7) *Harvard Law Review* 1489, 1504.

opponents try to replace them in order to influence the management of the company. In the past, contested elections were used only by potential acquirers, but now they are often used by activist funds who do not seek to gain the full control of the board but only to influence the strategy of the company. However, the limitations on shareholders' powers of nomination significantly reduce the disciplinary force of shareholder activism.

5.3.3.1.1 Historical Background to Proxy Access

The historical background to the reform of proxy access is important in order to understand the strength of corporate lobbying groups in the US and how they are able to shape corporate governance. In general, all discussion revolves around Rule 14a-8(i)(8)[188] which lays down the substantive basis for a company to exclude a proposal related to a board election and Rule 14a-11 which was invalidated by the court but would have provided the proxy access to shareholders.[189]

As mentioned above, proxy access has always been a subject of interest to the SEC. From 1942 up until the Enron collapse, proxy access had been reconsidered several times and was found to be unnecessary due to opposition from the business community.[190] In the wake of the Enron failure, proxy access was once again on the agenda of policy-makers. However, strong opposition from corporate lobbying groups, including corporations, executives, directors and law firms, meant that the SEC refused the proposal.[191] Instead, the SEC focused on increasing the independence of directors rather than allowing companies to make structural changes.[192] The fact that even a limited shareholder nomination right was not welcomed by corporate

[188] 17 CFR 240.14a-8(i)(8).
[189] *Business Roundtable v SEC*, 647 F. 3d. 1144 (D.C. Cir. 2011).
[190] See SEC, *Staff Report: Review of the Proxy Process Regarding the Nomination and Election of Directors*, 3 (2003) < https://www.sec.gov/news/studies/proxyrpt.htm> accessed 27 September 2016.
[191] SEC *Summary of Comments: In Response to the Commission's Proposed Rules Relating to Security Holder*.
Director Nominations, (5 March 2004) < https://www.sec.gov/rules/extra/s71903summary.htm> accessed 27 September 2016.
[192] Elizabeth Cosenza, 'The Holy Grail of Corporate Governance Reform: Independence or Democracy?' (2007) 2007 *Brigham Young University Law Review* 1, 6-7.

lobbying groups indicates how powerful these groups were in shaping corporate governance rules in the US.

Institutional investors, however, created self-help mechanisms through private ordering arrangements and proposed 'by-laws that would open the issuer's proxy to director nominations by shareholders – that is, direct access via by-law amendment rather than by SEC rule.'[193] AFSCME, a previously mentioned union pension fund, proposed a proxy access by-law to establish procedural conditions for shareholders to nominate directors. The board in that case excluded the proposal from the company's proxy card and the court held that the company could not exclude a shareholder proposal which seeks to establish a procedure under which shareholders can include their nominees in the proxy materials of the company.[194]

Following the *AFSCME* case, the SEC made an attempt to clarify the position. Accordingly, it first prepared an access proposal that would allow shareholders to establish the procedural rules for the nomination of candidates to the board.[195] However, the SEC adopted a non-access proposal which prohibits any proposal related to the nomination of a director or a procedure for such nomination[196] because of the belief that it would lead to 'contested elections for directors without adequate disclosure.'[197] According to Fisch, this 'was the most restrictive approach to shareholder nomination that the SEC had ever taken.'[198]

The historical pattern of continual rejection of proxy access reforms not only indicates the difficulty of drafting proxy access provisions, but also how the business community in the US has blocked shareholder proxy access.[199] In revising the proxy

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[193] Jeffrey Gordon, 'Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy' (2008) 61(2) *Vanderbilt Law Review* 475, 485.
[194] *American Federation of State, County & Municipal Employees, Employees' Pension Plan (AFSCME) v. American International Group* 462 F.3d 121, 123-24 (2d Cir. 2006).
[195] SEC, *Shareholder Proposals*, Release No. 56160, Investment Company Act Release No. 27913, (2 October 2007); See also Marilyn Cane and Stacey Silva, 'Shareholder Democracy and the SEC's Proxy Rules: in the Boardroom' (2009) 15(1) *Fordham Journal of Corporate & Financial Law* 241, 250-1.
[196] SEC, *Shareholder Proposals*, Release No. 56160, IC-27914, 72 Fed. Reg. 43,466, 43,487 (3 Aug 2007); SEC *Shareholder Proposals Relating to the Election of Directors* Release No. 34-56161; IC-27914; SEC, *Shareholder Proposals Relating to the Election of Directors*, Release No. 56914, IC-28075, 72 Fed. Reg. 70,450 (11 Dec. 2007).
[197] See SEC Release No. 56914 (n 196).
[198] Fisch (n 181) 644.
[199] Fairfax (n 186) 1278.

access rules, the SEC failed to consider the role of contemporary shareholder activism in addressing accountability concerns and in enhancing shareholder value. A prohibition on access to proxy statements of companies and the adoption of private ordering for proxy access unreasonably favours management. The nomination right already exists in state law, but the SEC only prevents shareholders from exercising the right to nominate effectively.

The 2007-2008 financial crisis revived the shareholder empowerment debate to increase the accountability of directors. In contrast to the response to the Enron collapse, law makers directly aimed to enhance the nomination powers of shareholders by passing the Dodd-Frank Act. In this regard, the SEC proposed an amendment seeking to change Rule 14a-8(i)(8) and to introduce a new version of Rule 14a-11.[200] This proposal was adopted.[201]

5.3.3.1.2 Rule 14a-11

Rule 14a-11 would basically have allowed shareholders to have proxy access to nominate up to 25% of the board if shareholders or a group of nominating shareholders held at least a 3% ownership interest for at least three years. The rule was designed on a mandatory basis, i.e. the terms of Rule 14a-11 would apply regardless of whether a company had proxy access or not.

A company was not required to include more than one candidate or candidates representing up to the 25% of the board, whichever was the greater. Direct access to the corporate ballot reduced a substantial part of the costs of running a proxy contest and made shareholder activism more meaningful. In light of the fact that the board had already been sending and receiving proxy cards from shareholders, such a change balanced the disadvantageous position of rivals. The rule was invalidated by the court

[200] SEC, *Facilitating Shareholder Director Nominations* Exchange Act Release No 60,089 IC-28765, 74 Fed. Reg. 29024 (18 June 2009) (hereinafter referred to as 'proposing proxy access rule').

[201] SEC, *Facilitating Shareholder Director Nominations*, Securities Act Release No. 9136, Exchange Act Release No. 62764 IC-29384, 75 Fed. Reg. 56668 (16 September 2010); Section 971 of the Dodd-Frank Act.

but still reflects the SEC’s efforts and willingness to increase shareholder engagement.[202]

The minimum ownership threshold was the most controversial condition in the debate on the shareholders’ nomination power. The idea behind the minimum ownership threshold for nominating a director was to provide this right to a shareholder who had a substantial financial interest in the company and to prevent unnecessary contests in the company. Given the institutional share ownership of listed companies, this threshold may appear appropriate and could have prevented any potential abuse by shareholders who had no material ownership in the company.

Rule 14a-11 also requires continuous share ownership for at least 3 years. Bearing in mind that the average holding period of hedge funds is around 1.5 years, this condition significantly undermined the value of contemporary shareholder activism. It left only mainstream institutional shareholders as shareholders that could exercise the nominating power. While mainstream institutional shareholders have become active owners, they usually engage in more reticent forms of shareholder activism. Although the SEC’s preference was to provide a nominating power to long-term investors to address the short-termism problem, as shown in Chapter 3, the short-termism arguments are not fully supported. Furthermore, Chapter 4 showed that activist funds are better incentivised to identify the existing agency gaps and to fill them. Therefore, a 3-year period would likely have prevented the only remaining shareholders - namely activist hedge funds - from nominating directors. The impact of such a rule would be limited.

5.3.3.1.3 Rule 14a-8(i)(8)

The 2009 amendments of Rule 14a-8(i)(8) basically reversed the 2007 changes. This enables shareholders to submit shareholder proposals concerning nomination procedures as long as the proposals was not in conflict with the proposed Rule 14a-11. While shareholders do not now have a default proxy access, they are able to establish nomination procedures through private ordering. In the past, Rule 14a-8 has

[202] *Business Roundtable v SEC*, 647 F. 3d. 1144 (D.C. Cir. 2011).

limited the ability of shareholders to adopt nomination procedures through private ordering. Shareholders were able to distribute the proposal independently rather than through the companies' proxy material, but as discussed before, the independent proxy campaigns are usually prohibitively expensive. This was an important impediment to the exercise of shareholders' nomination rights.

Proxy access proposals have become very topical in the US recently. In 2015, around 190 of the S&P 500 companies adopted proxy access proposals.[203] Shareholder access to proxy material is increasingly becoming the market norm. The approval of these proposals also reflects the increased willingness of institutional investors to engage in corporate governance because similar proposals failed to receive the support of majority shareholders in 2007.[204] The key terms of proxy access proposals show similarities with each other. The majority of the proxy access proposals have a 3% ownership threshold, a 3-year holding period, a 20% maximum restriction on the number of existing directors and an aggregation limit of 20 shareholders.[205] Chapter 4 discussed how shareholder nominees could address the structural deficits of the monitoring board. Therefore, any limitation on the number of shareholder nominees undermines the value of shareholder activism. The aggregation limit would also deter middle-scale institutional investors from nominating directors. Thus, it has a negative impact on the effectiveness of proxy access. As discussed in the context of Rule 14a-11, a 3-year holding period reduces the ability of activist funds to nominate directors. Other funds may not be willing to nominate directors as much as the activist funds. These limitations therefore dilute the expected impact of proxy access.

5.3.3.2 Delaware Law on Director Elections

Shareholders' nominating powers are given by state laws,[206] while their proxy access is regulated through federal law. In theory, shareholders can nominate a director at the general meeting but because of the dispersed shareholdings of companies, without

[203] Sullivan & Cromwell LLP, '2016 Proxy Season Review' (11 July 2016) < https://www.sullcrom.com/siteFiles/Publications/SC_Publication_2016_Proxy_Season_Review.pdf > accessed 01 October 2016.
[204] Lisa Fairfax, 'The Future of Shareholder Democracy' (2009) 84 *Indiana Law Journal* 1259, 1270.
[205] Sullivan (n 203).
[206] Lawrence Hamermesh, 'Director Nominations' (2014) 39 *Delaware Journal of Corporate Law* 117, 150.

proxy solicitation, such nominations are ineffective. State laws theoretically allow companies to customise the nomination procedure through charter and by-law provisions that limit or facilitate the nomination of directors by shareholders. The ability of companies to exclude proposals under Rule 14a-8(i)(8) and the recursive loop between sections 109(a) and 141(a) have long impeded the effective use of private ordering in the context of director elections.

Even in an uncontested election, shareholders should be able to demonstrate their dissatisfaction with the management and to unseat a director. However, the default regime in Delaware law[207] is the plurality voting rule (PVR). The PVR means that the candidates who receive the most affirmative votes are elected without regard to votes against or not cast. In an uncontested election, the PVR prevents shareholders from voting down a nominee put forward by the company because a director could be elected by a plurality of the votes without considering withheld votes or the votes against. One affirmative vote could in theory be enough for a director to be given a seat on the board. In 2009, 93 directors at 50 companies failed to receive the majority of votes cast at their respective general meetings but nevertheless managed to secure seats because of the plurality system.[208] Thus, under the PVR model, there is a lack of a genuine threat of removal of directors.

The PVR has produced a great deal of criticism and activist investors waged 'withhold-the-vote' and 'just say no' campaigns against the election of particular candidates.[209] Moreover, activist investors forced companies to switch from plurality voting to majority voting in order to improve director elections in 2005.[210] Under the majority voting rule (MVR), a director has to receive the majority of votes cast in the election in order to be elected. In other words, it prevents any director from being elected if he/she fails to receive the support of a majority of the shareholders. It rectifies the shortcomings of PVR and provides an inexpensive way of disciplining management. The threat of replacement is gaining credibility. In order to ensure a

[207] Section 216 of the DGCL.
[208] Joann Lubnin, 'Directors Lose Elections, but not Seats' *The Wall Street Journal* (28 September 2009) < http://www.wsj.com/articles/SB125409320578444429> accessed 29 September 2016.
[209] Fairfax (n 186) 1289.
[210] Stephen Choi et al., 'Does Majority Voting Improve Board Accountability' (2016) 83 *The University of Chicago Law Review* 1119.

smooth transition, section 141(b) of the DGCL articulates that ‘each director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal’. This is called a ‘holdover rule’. This rule minimises the negative implications of a failed election. With the ‘holdover rule’, the director would remain in the board after an uncontested election despite being rejected by shareholders, but this would only be temporary measure. The rejected director would be under pressure to transfer the directorship to a new director. So while the holdover rule delays the effect of a shareholder vote, it does not necessarily render director elections meaningless. Institutional shareholders have showed great interest in majority voting. In 2005, only nine of the S&P 100 companies had adopted the MVR but by 2014 almost 90% of the S&P 500 companies had applied the MVR.[211] This is a significant improvement, which was generated by the market as a result of action by institutional investors. Unlike the by-laws regarding general issues, the by-laws relating to MVR are protected under Delaware law and cannot be repealed by the board of directors.[212]

In parallel to the SEC’s reform initiatives in 2009, Delaware amended its corporate code to allow shareholders to adopt a by-law which permits proxy access.[213] Although many commentators had thought this kind of proposal would be valid under Delaware law, the former version of 14a-8 precluded the courts from resolving this issue by immediately allowing the board to exclude the shareholder proxy access proposals.[214] Section 112 now explicitly allows companies to establish a procedure for director elections that permits proxy access.

A further issue with regards to nomination by shareholders is ‘golden leashes’. As discussed in Chapter 4, this method is highly controversial. It was argued earlier that shareholder nominees provide the independence of the board which is necessary for

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[211] Choi et al., (n 210) 1121.
[212] Section 216 of the DGCL.
[213] Section 112 of the DGCL; see in *CA Inc. v. AFSCME*, where the court upheld a bylaw related to the process and procedure by which decisions are taken. *CA Inc. v. AFSCME*, 953 A.2d 227 (Del. 2008). This provided leeway for other bylaws related to the process and procedure.
[214] Leo Strine, ‘Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward’ (2008) 63(4) *The Business Lawyer* 1079, 1086-8.

contemporary shareholder activism.[215] However, since the candidates might have made a number of changes set by the activist fund in return for additional payments conditional on the specified changes, an elected director could feel beholden to her or his sponsor or obliged to follow her or his sponsor's strategy for the target company. While this concern has substantial merit, it obscures the real underlying doctrinal framework, independent legal doctrine and the duty of loyalty. Concerns not only arise as a result of the substance of the changes, but also from the impact of the bonus payment on the independent judgment of directors.

In extreme cases, this might affect the business discretion of directors, but such a situation has yet to be reached. The courts have adopted a similar approach. In *Frank v. Elgamal*, the Court held that:

> '… merely because a director is nominated and elected by a large or controlling stockholder does not mean that he is necessarily beholden to his initial sponsor'.[216]

In *Kahn v. M & F Worldwide*, the Court held that:

> 'past business relationships with the proponent of a transaction or the person they are investigating are not enough to rebut the presumption of independence'.[217]

This shows that the mere fact that there has been a financial relationship may not be enough to challenge the independence of directors. Instead, material issues that affect a director's ability to assess objectively the relevant changes in companies must be demonstrated. It therefore appears that golden leash clauses alone are not enough to challenge per se the independence of directors under Delaware law and constitute a breach of fiduciary duty. Moreover, in 2016, NASDAQ addressed these concerns by requiring listed companies to disclose the payments by third parties to the directors or

[215] See also Yaron Nili, 'Servants of Two Masters? The Feigned Hysteria Over Activist-Paid Directors' (2016) 18(2) *University of Pennsylvania Journal of Business Law* 510; Adam Prestidge, 'Activist Compensation of Board Nominees and the Middle Ground Response' (2015) 11(2) *Hastings Business Law Journal* 306.
[216] *Frank v. Elgamal*, C.A. No. 6120-VCN (Court of Chancery of Delaware, 10 March 2014);
[217] *Kahn v. M&F Worldwide Corp*., 88 A.3d 635, 648-49 (Supreme Court of Deleware 2014).

nominees.[218] Enhanced disclosure provides a balanced protection against potential abuse by activist funds.

Overall, there have been significant developments in the procedure for the elections of directors. The courts have long relied on the ability of shareholders to choose a new director in justifying their strong degree of deference to the board's authority. However, this has not been the case in practice and shareholders have long been precluded from nominating directors or even withholding votes. More importantly, they have been prevented from submitting shareholder proposals regarding any procedure for the directors' elections, which goes against the grain of the enabling nature of US corporate law. US law has now at least lowered the impediments to private ordering. However, the default regime of US corporate governance still maintains obstacles to shareholder activism.

5.3.4 Removal of Directors

State corporate law not only regulates the nomination and appointment of directors but also the removal of directors. Shareholders possess an inherent power to remove directors with or without cause by a simple majority of shares under section 141(k). The existence of this shareholder power to remove directors is particularly important in terms of corporate governance because in the absence of such express authorisation, directors could only be removed at the end of their term of appointment or if the director had been grossly negligent.[219]

This default position does not apply if the board is staggered.[220] In other words, shareholders can remove directors only with cause. Even if the company does not have a staggered board, shareholders do not possess the right to call a general meeting; they have to wait until the next director election. This has led to the common assumption that it is more difficult for US shareholders to remove directors than UK

[218] Rule 5250(b)(3) of the NASDAQ.

[219] See *Alderstein v Wertheimer* 2002 WL 205684 (Del 2002).

[220] A staggered board refers to a situation in which 'directors are grouped into classes (typically three), with each class elected at successive annual meetings'. Lucian Bebchuk et al., 'The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy' (2002) 54 *Stanford Law Review* 887, 893.

shareholders.[221] In the UK, section 168 of the Companies Act 2006 stipulates that a director can be removed by a simple majority of shareholders at any time without any reason for doing so.[222]

The existence of staggered boards does constitute a significant impediment to shareholder activism as well as the proper functioning of the market for corporate control. In a staggered board, a director could be up for re-election every 2 or 3 years.[223] Therefore, in the US, the directors' contract terms are not coterminous. Classified boards grant an additional layer of insulation to the board of directors in the case of hostile takeovers because the prospective acquirer of the company will have to wait at least 2 years to gain control which means that it has to launch at least two expensive proxy contests in consecutive years. The resulting cost and time delay therefore significantly deters potential acquirers and Bebchuk et al. consider it the most powerful anti-takeover mechanism.[224] The staggered board reduces the power of shareholders to replace the board of directors and to influence the manner in which the company is managed.[225] The reason why Delaware law enables the board to 'opt-out' from the removal without cause rule is to favour board stability and autonomy from shareholder participation. In this regard, Delaware law provides contractual freedom to the board as a means of balancing the power between shareholders and directors on a proactive and ex ante basis.

The classified board used to be a very common practice in the US. In 1999, 303 S&P 500 companies had classified boards.[226] Institutional shareholders have been actively opposing staggered boards, and since then, have been supporting shareholder resolutions to declassify boards.[227] In the past, although shareholder proposals to abolish classified boards often received majority support, the boards did not

221 Bruner (n 2) 29.
222 Section 168(1) of the CA 2006.
223 Code Provision D.1.5 of the UK Corporate Governance Code.
224 Bebchuk (n 220) 925, 944-5.
225 Lucian Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118(3) *Harvard Law Review* 836, 853.
226 Lucian Bebchuk, Scott Hirst and June Rhee, 'Towards the Declassification of S&P 500 Boards' (2013) 3 *HBLR* 158, 165.
227 Bebchuk et al (n 226).

implement at least two-thirds of such proposals.[228] However, as a result of the increased power of institutional investors, the boards have responded to shareholders' claims positively, with the number of staggered boards in S&P 500 companies reduced to 126 at the beginning of 2012 (from 303 in 1993); and during 2012, 42 of these 126 companies also removed the staggering of their boards.[229]

Shareholders in the US have gained the ability to elect an entire board in the market, which is a necessary component of shareholder voting power. This is an important development that makes director elections more meaningful, but it needs to be supported by a straightforward nomination process to make the threat of shareholder activism more credible.

5.3.5 Defensive Mechanisms in the Context of Takeovers

The widespread use of defensive mechanisms is a highly controversial aspect of US corporate governance. While UK law adopted a market-based approach and regulated takeovers through a market-based institution, the US left the issue of hostile takeovers to the courts. The UK legal framework prohibits employing anti-takeover tactics without the consent of shareholders and is strikingly shareholder orientated.[230] Regulation in the UK has been based on the 'no frustration' rule which prevents the board from adopting defensive mechanisms 'during the course of an offer, or even before the date of the offer if the board of the offeree company has reason to believe that a bona fide offer might be imminent'.[231] Given that the majority of US public companies are incorporated in Delaware,[232] the courts of Delaware have played a key role in the development of takeover rules in the US. In the literature, it is argued that

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[228] Bebchuk (n 225) 854.
[229] Bebchuk et al., (226) 165-7, 171; see also, Marcel Kahan and Edward Rock, 'Embattled CEOs' (2009) 88 *Texas Law Review* 987, 1008.
[230] John Armour et al., 'Shareholder Primacy and the Trajectory of UK Corporate Governance' (2003) 41(3) *British Journal of Industrial Relations* 531, 534.
[231] Rule 21 of The City Code on Takeovers and Mergers (the Takeover Code); See also general principle 3 of the Takeover Code.
[232] Daniel Greenwood, 'Democracy and Delaware: The Mysterious Race to the Bottom/Top' (2005) 23 *Yale Law & Policy Review* 381.

US law provides shareholders with a far less limited role in the area of hostile takeovers compared to UK law.[233]

In the 1970s and 1980s, when the hostile tender offer wave was at its height, management developed defensive mechanisms to deter takeover bids.[234] The most common defensive tactic was the 'poison pill', often called a 'shareholder rights plan'.[235] This is a mechanism designed to dilute the value of a hostile bidder's stock. This mechanism achieves its goal by granting existing shareholders the option to purchase new shares at a discounted price in the company. Poison pill rights are generally expressed in the charter or by-laws and triggered when a person or group acquires a significant block of shares in the target company. Once the poison pills and the staggered boards are applied at the same time, the firm becomes almost 'takeover-proof'.

The court had basically two main options: to allocate power to shareholders or directors. The merits of each approach are hotly debated and inconclusive in the contractarian school of thought.[236] The Delaware courts have developed arguably a middle ground solution. By recognising the inherent conflict of interest between the board and shareholders in the context of takeovers, it has not applied the traditional business judgment rule, but it does not overlook the potential benefits that an independent board could contribute to decision-making processes even if it is related to control-related transactions. The court developed an 'enhanced scrutiny test'[237] in

[233] John Armour and David Skeel 'Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation' (2007) 95 *The Georgetown Law Journal* 1727; Bruner (n 2) 40.
[234] Bainbridge (n 85) 677; Howard Friedman *Publicly Held Corporations A Lawyer's Guide* (OUP 2011), 203.
[235] See Bainbridge (n 234), 677-90.
[236] Frank Easterbrook & Daniel Fischel, 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981) 94 *Harvard Law Review* 1161, 1164; Lucian Bebchuk, 'The Case Against Board Veto in Corporate Takeovers' (2002) 69 *The University of Chicago Law Review* 973; Ronald J Gilson, 'The Case against Shark Repellent Amendments: Structural Limitations on the Enabling Concept' (1981) 34 *Stanford Law Review* 775; Martin Lipton and Paul Rowe, 'Pills, Polls and Professors: A Reply to Professor Gilson' (2002) 27 *Delaware Journal of Corporate Law* 1; William Allen et al., 'The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide' (2002) 69 *The University of Chicago Law Review* 1067; Lynn Stout 'Do Antitakeover Defences Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem' (2002) 55 *Stanford Law Review* 845.
[237] See Travis Laster, 'Effect of Stockholder Approval on Enhanced Scrutiny' (2013) 40 *William Mitchell Law Review* 1443.

Unocal Corp v. Mesa Petroleum Inc.[238] to review the defensive mechanisms employed by the board to ward off the hostile bid.

The *Unocal* case established that where the board has employed defensive mechanisms, the burden of proof shifts to the board to demonstrate both a- 'reasonable grounds for believing that there is a danger to corporate policy and effectiveness' and b- the proportionality of the employed defensive measures. The *Unocal* test constitutes a threshold or additional procedural mechanism in determining whether the board is entitled to strong deference in terms of the business judgment rule.

Not all kinds of threats, however, justify defensive mechanisms; the boards need to take into account a number of factors ranging from inadequacy of the offer to the impact on other stakeholders other than shareholders.[239] However, the substantial element of the examination of threat depends on whether it entails 'substantive coercion', which was developed by Gilson and Kraakman.[240] Under this classification, substantive coercion refers to 'the risk that shareholders will mistakenly accept an under-priced offer because they disbelieve management's representations of intrinsic value'.[241]

In *Paramount Communications Inc. v. Time Inc.*, the board of Time blocked a hostile offer from Paramount to carry out a long-planned merger with Warner Brothers. This was despite the fact that Paramount made an offer to buy all the shares in Time for \$175 per share when the market price was around \$126.[242] The board found this offer inadequate and expressed 'their concern that Time stockholders would not comprehend the long-term benefits of the Warner merger. Large quantities of Time shares were held by institutional investors.[243] In *Paramount*, it is difficult to identify whether it was a commercial necessity or the honest belief of the board rather than managerial entrenchment because Time also entered into an agreement with other

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[238] *Unocal Corp v Mesa Petroleum Inc*, 493 A 2d 946, 953 (Del. Sup. Ct. 1985).
[239] *Unocal* (n 238) 956.
[240] Ronald Gilson and Reiner Kraakman, 'Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?' (1989) 44 *The Business Lawyer* 247, 267; *Air Products & Chemicals, Inc. v. Airgas, Inc.*, 16 A. 3d 48, 96 (Del 2011).
[241] Gilson and Kraakman (n 240) 267.
[242] *Paramount Communications, Inc. v. Time Inc.*, 571 A. 2d 1140, 1148, n 17 (Del 1989).
[243] Paramount (n 242) 1148; the same view was reiterated in *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del.1995).

banks not to finance third parties other than Warner who wanted to take over Time. However, the court upheld the anti-takeover mechanisms employed by the board and found a protectable interest in maintaining the pre-existing business plan and expanded the scope of the threat beyond the immediate economic interests of shareholders. While the substantive coercion doctrine aimed to prevent the board from blocking non-coercive bids, the courts could be over-permissive of defensive mechanisms, depending on the interpretation of the two prongs, and boards are indeed allowed to 'just say no' in the case of a hostile bid.[244] The court provided an 'authoritative stamp of Delaware' to management.[245]

It is difficult to agree with the court's reasoning and the open-ended interpretation of the *Unocal* test in the age of shareholder capitalism. Institutional shareholders now have the capacity to comprehend long-term business strategies and evaluate the company's culture and can bring new information to the board in deciding on the future of the company. This line of argument has also been recognised and supported by the Delaware Court of Chancery in reviewing the poison pill in *Airgas v. Air Products & Chemicals.*[246] The court held that:

> 'Airgas's stockholder base is sophisticated and well-informed, and that essentially all the information they would need to make an informed decision is available to them. In short, there seems to be no threat here—the stockholders know what they need to know (about both the offer and the Airgas board's opinion of the offer) to make an informed decision.'

Despite this recognition, the court felt bound by well-established case law. Since broad and often vague justifications can satisfy the first prong of the *Unocal* test, the law is over-permissive to defensive mechanisms and, more importantly, it is impossible to distinguish the real motivation behind the defensive mechanism. Effectively,

[244] Mary Siegel, 'The Illusion of Enhanced Review of Board Actions' (2013) 15 *University of Pennsylvania Journal of Business Law* 599, 621 ('Directors' seventy-nine percent success rate under Unocal increased to a minimum of eighty-four percent when they had independent boards').
[245] Jeffrey Gordon, 'Corporations, Markets, and Courts' (1991) 91 *Columbia Law Review* 1931, 1933.
[246] *Airgas v. Air Products & Chemicals* 16 A. 3d 48, 57 (Del. Ch. 2011).

Delaware allowed boards to 'just say no' in the case of a hostile bid by expanding the scope of the threat.

In recent years, institutional shareholders and proxy advisory firms have prepared shareholder proposals and have launched public campaigns against poison pills.[247] Boards take proposals to remove poison pills seriously. Their number has decreased substantially in the last decade and are expected to continue to decline.[248] As a result of these sustained attacks, poison pills are no longer as prevalent as they were in the past. Removing a poison pill does not ensure the board will not adopt a new poison pill unless a charter amendment is made that limits the board's power to do so. This movement significantly reduces the power of poison pills in the context of shareholder activism in US corporate governance.

To sum up, alongside anti-takeover statutes, the adoption of a broad interpretation of a threat has led to an over-permissive approach. This approach restricts the proper functioning of the market for corporate control as discussed in Chapter 2. However, the proposals to remove poison pills have gained market-wide success and in reality, poison pills are not as prevalent as they were in the past, along with classified boards and plurality voting.

5.3.6 Defensive Mechanisms in the Context of Shareholder Activism

Defensive mechanisms could also be employed to prevent any shareholder from accumulating a sizeable as opposed to a controlling stake in a target company. It is yet to be seen if boards will systematically adopt defensive mechanisms to dilute the power of institutional shareholders and whether the courts will uphold these defensive mechanisms or will appreciate the value-enhancing role of shareholder activism.

In a very recent case, *Third Point LLC v. Ruprecht*, the court upheld poison pill arrangements which were designed to ward off activist funds.[249] The court applied

[247] Marcel Kahan and Edward Rock, 'Symbolic Corporate Politics' (2014) 94 *Boston University Law Review* 1997, 1999; Leo Strine, 'Can We Do Better by Ordinary Investors? A Pragmatic Reaction to The Duelling Ideological Mythologists of Corporate Law' (2014) 114 *Columbia Law Review* 449, 470.
[248] Guhan Subramanian, 'Delaware's Choice' (2014) 39 *Delaware Journal of Corporate Law* 1, 31.
[249] *Third Point Llc v. Ruprecht* No. 9469-VCP (Del. Ch. 2014).

the *Unocal* test in reviewing the board's action. In doing so, the court might have felt obliged to employ the enhanced scrutiny test because it held that courts must apply the *Unocal* test in reviewing the defensive mechanisms adopted by boards of directors.[250] In the case of *Third Point LLC v. Ruprecht*, William Ruprecht was the chairman, president and CEO of Sotheby's, the target company, and Third Point was a hedge fund holding which had accumulated 9.4% of the shares of Sotheby's. After Third Point's stake reached 9.6%, the board adopted a Rights Plan. Applying the first prong of the *Unocal* test, the court held that the board had reasonable grounds to regard Third Point as a legally recognisable threat. The court found a potential 'conscious parallelism' between activist funds. While it did not provide an exact definition of 'conscious parallelism', it stated that there 'was the objectively reasonable possibility that Third Point was working in connection with one or more other hedge funds in an attempt to create a control block within the Company's stockholder base'.[251] Similarly, in *Yucaipa American Alliance Fund II, LP v. Riggio*, the court justified the poison pill which was designed to be triggered at 20% activist ownership to prevent 'the formation of a de facto control … through conscious parallelism'.[252] In this respect, where activist funds are acting together to carry out a common target, they could be deemed as a threat to corporate policy. As regards the second prong of *Unocal*, the court held that the plan was proportionate as there was a reasonable threat. A higher threshold would make it easier for hedge funds acting with 'conscious parallelism' to accumulate a sizeable stake 'without paying a premium'.[253] In short, the implementation of the rights plan met the requirements of the *Unocal* test.

The application of the *Unocal* test may give excessive power to the board and management because the first prong requires there to be a danger to corporate policy. However, contemporary shareholder activism in fact aims to make changes to the business strategy of the company. Such understanding significantly undermines the value of shareholder activism. In examining the proportionality of the poison pills, the court emphasised the possibility that hedge funds can act with 'conscious parallelism'.

[250] *Moran v. Household International, Inc.,* 500 A.2d 1346 (Del. 1985); *MM Cos. v. Liquid Auto, Inc.,* 813 A.2d 1118, 1130 (Del. 2003).
[251] *Third Point LLC* (n 249) 20.
[252] *Yucaipa American Alliance Fund II, LP v. Riggio* 1 A.3d 310, 359-60 n. 254 (Del. Ch. 2010).
[253] *Third Point LLC* (n 249)16.

Conscious parallelism is a vague term. It is based on the possibility that activist funds could act together, even if there is no formal agreement between them. More importantly, they regard 'conscious parallelism' as a reasonable threat to the board. The use of 'conscious parallelism' can become over-permissive due to the lack of a clear definition.

The courts' approach can encourage boards to implement broader and stronger poison pills which in turn reduce the incentives of shareholders to engage with companies as activists. This increases the cost of shareholder activism substantially. This excessively punitive approach may make it difficult for shareholders to form coalitions and thereby reduce the power of shareholders as well as increase agency costs and managerial inefficiency. The courts could find a way to accommodate shareholder activism as a monitoring tool and an accountability mechanism in general into their judgments.

How would courts incorporate the evolving nature of shareholder activism into their decisions? Shareholder activism inherently aims to bring change to board policies. The courts could incorporate shareholder activism into their decision by softening the understanding of section 141(a).[254] A softer interpretation of section 141(a) would provide sufficient room for shareholder activism. In light of this, the court could soften its paternalistic approach by recognising the fact that institutional investors have the capacity to make independent decisions when they are faced with shareholder proposals and that shareholder activism in its many varied forms could enhance shareholder value and reduce agency costs and managerial inefficiency. Shareholders now have the capacity to evaluate takeover bids, shareholder proposals and the qualifications of board candidates. As Gilson, who was one of the developers of the substantive coercion doctrine, and Gordon now argue: 'substantive coercion is no longer a useful doctrinal account of the circumstance faced by today's shareholders

[254] 'The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.'

in the large public companies domiciled in Delaware'.[255] Even Lipton, who created poison pills, accepts that institutional investors do not blindly approve recommendations made by activist funds and do consider well-designed business strategies for the sustainability of companies.[256] In *Airgas*, there were signs of change in the court's perception of shareholders. The judgment of the *Unocal* case provides sufficient flexibility to the courts; it stated: '… our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs'.[257] Therefore, courts could recognise the fact that shareholders in the market are now capable of understanding and evaluating activist proposals properly, with the guidance of the board of directors.

Overall, the board is given almost near-absolute authority in US law. The board is allowed to employ defensive mechanisms in the case of shareholder activism. This could potentially reduce the incentives of shareholders to be active and inevitably creates an unnecessary tension between shareholder activism and corporate law.

5.3.7 Say on Pay

Say on pay is employed by company law to monitor self-enrichment by directors and managers. It enables shareholders to have input into executive compensation in order to control excessive remuneration problems in corporate governance. Say on pay has recently become an important aspect of US corporate governance and around the world[258] in monitoring agency costs arising from executive remuneration contracts discussed in Chapter 2.[259]

Say on pay has been an aspect of US corporate governance since 2006, even though it was codified after the financial crisis. Institutional investors have been

[255] Ronald Gilson and Jeffrey Gordon, 'Agency Capitalism: further implications of equity intermediation' in Jennifer Hill and Randall Thomas (eds) *Research Handbook on Shareholder Power* (Edward Elgar 2015) 32, 48.
[256] Martin Lipton, 'Dealing with Activist Hedge Funds' (HLSFCGF 2 June 2015) <https://corpgov.law.harvard.edu/2015/06/02/dealing-with-activist-hedge-funds-4/> accessed 16 September 2016.
[257] *Unocal* (n 238) 957.
[258] Randall Thomas and Christopher Van Der Elst, 'Say on Pay Around the World' (2015) 92 *Washington University Law Review* 652.
[259] Jeffrey Gordon 'Executive Compensation: If There's A Problem, What's the Remedy? The Case for 'Compensation Discussion and Analysis'' (2005) *The Journal of Corporation Law* 675, 698.

submitting non-binding say on pay proposals under 14a-8 since 2006.[260] Corporate management has resisted these kinds of proposals on the grounds that the board of directors is responsible for setting executive pay and this would prevent the board from acting effectively.[261] In the UK, shareholders have had an annual advisory vote on the implementation report of the executive remuneration since 2002 (and a binding vote on the directors' remuneration policy since 2013);[262] a similar approach was not taken in the US until the 2007-2008 financial crisis.

The Dodd-Frank Act addresses executive remuneration in sections 951-957. Section 951 of Dodd-Frank requires an advisory vote on executive remuneration to take place at least once every 3 years. An advisory vote is also required for golden parachutes. This section regulates the form of the say on pay proposal and the position of executives that are subject to the vote. The US expanded shareholders' rights in the process of executive pay settings despite the fact that the vote is not binding and enhanced the disclosure requirements with regards to executive remuneration. Shareholders vote only for the overall compensation package and do not have a voice in the specific provisions of remuneration packages.

Bainbridge criticises this regulation because he argues that it is 'expected to affect director decisions' and interfere with the board's authority.[263] Some empirical evidence suggests that say on pay regulation has not led to a substantial reduction in overall executive pay.[264] However, Correa and Lel found robust evidence that say on pay regulation decreases the growth rate of executive pay in comparison with other countries that do not have say on pay. [265] It could be argued that the say on pay regulation has led to a relative decline in executive pay.

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[260] Thomas and Elst, (n 258), 659.
[261] Thomas and Elst (n 258), 659.
[262] Sections 420 and 439A of the CA 2006.
[263] Stephen Bainbridge, 'Dodd-Frank: Quack Federal Corporate Governance Round II' (2011) 95 *Minnesota Law review* 1779, 1812.
[264] Vicente Cunat et al, 'Say Pays! Shareholder Voice and Firm Performance' (2015) 20(5) *Review of Finance* 1.
[265] Ricardo Correa and Ugur Lel, 'Say on Pay Laws, Executive Compensation, Pay Slice, and Firm Value Around the World' (2014) *International Finance Discussion Papers* Number 1084 < file:///C:/Users/s1270620/Downloads/SSRN-id2328678.pdf> accessed 10 October 2016.

It is puzzling why shareholders do not vote down excessive executive remuneration packages.[266] There are two explanations for continuing support for executive pay practices. First, it has been observed that negative vote recommendations of proxy advisory firms lead to compensation plan changes and make companies more responsive to shareholder views.[267] Before the vote takes place, the communication between shareholders and management may lead to revisions to the pay arrangements, i.e. it increases the negotiating power of shareholders in the shadow of the law. In short, it increases the pay for performance sensitivity of companies. In the shareholder meeting, shareholders vote for what they consented to before the meeting. Second, and more importantly, contrary to the widespread belief that a shareholder vote would keep overall executive remuneration at reasonable levels, shareholders have tended to focus on the company's performance. When shareholders consider there is misalignment between the performance of the company and executive pay, then they are likely to refuse executive pay proposals.[268]

In conclusion, the say on pay regulation has had a significant impact on US corporate governance. It has increased the disciplinary power of shareholders. This recent change provides shareholders an additional right to participate in corporate governance and an additional line of communication between shareholders, the board, and management. In this regard, a shift from near-absolute board authority (board centrism) is happening in US corporate governance.

5.3.8 Concluding Remarks: A Paradigm Shift in the US?

US corporate governance is in a state of flux and evolving. The market-driven process of shareholder proposals has led the law in action to evolve at a greater pace than law on the books. Legal reforms in the US and market driven changes could be underestimated by those ignorant of US law because many rights such as the right to

[266] James F. Cotter et al., 'The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward' (2013) 81 *The George Washington Law Review* 968, 980.
[267] Paul Edelman et al., 'Shareholder Voting in an Age of Intermediary Capitalism' (2014) 87 *Southern California Law Review* 101, 170.
[268] See Ryan Krause et al., 'Power to Principals! An Experimental Look at Shareholder Say-On-Pay Voting' (2014) 57 *Academy of Management Journal* 94.

nominate directors or the right to submit proposals could be regarded as basic rights of shareholders.

Although US company law is known to be flexible and enabling in the internal structure of corporate governance, in practice the board controls the allocation of power between shareholders and directors. The board and top management are in charge of the corporate proxy system, which carries out formal communications with shareholders and disseminates important information to shareholders. The courts' near-absolute interpretation of section 141(a) and federal law has long restricted shareholders' ability to adopt new governance rules. This effectively closes decision-making to shareholder participation. Many issues such as employee recruitment, anti-discrimination or weakness of current business strategies cannot be raised by shareholders. More importantly, shareholder proposals relating to directorial elections including the nominations of directors and election procedures have been prohibited until recently. Shareholders have been left with a costly proxy contest option to challenge management. In sum, shareholders are practically precluded from bringing their own resolutions.

Shareholder participation has not been a primary theme in the US in contrast to the protection of shareholder interests. Following the 2007-2008 financial crisis, shareholder empowerment has been preferred as a governance strategy which aims to increase shareholder participation in corporate decision-making in order to address accountability concerns. The Dodd-Frank Act provided shareholders with the legal power to submit shareholder proposals regarding director nomination procedures and say on pay. More importantly, corporate governance changes are being made through private ordering, i.e. shareholder proposals in the market. Institutional shareholders are aware of shareholder rights in other jurisdictions and are keen to transfer different types of shareholder activism between jurisdictions.

Institutional shareholders are now reshaping US corporate governance in the market. Companies are removing staggered boards and increasingly separating the roles of chairman and CEOs in the US. In the US, the board has the power to adopt defensive mechanisms in the case of take-overs or offensive shareholders. However, in practice defensive mechanisms are becoming rare. This therefore increases shareholder power in the course of take-overs or shareholder activism. The majority of companies now provide the right to convene a meeting. MVR has become the market norm. Accordingly, the ability of shareholders to replace directors has increased significantly. In addition, the Dodd-Frank Act has allowed shareholders to submit proposals through Rule 14a-8 in order to have proxy access to the ballot within individual firms and provides say on pay.

The reforms in the legal and regulatory rules, the emergence of activist funds and the new paradigm developed by mainstream investors is causing a seismic change in US corporate governance which is now clearly evolving towards a more shareholder friendly model. This appears to challenge the traditional assumptions about the US corporate governance model. Shareholders who were formerly relegated to the side-lines are now slowly moving to the centre of US corporate governance. This study considers these developments a promising foundation for the evolution of relationship between the board and shareholders.

This is not the end of story because private ordering through by-laws can be used by the board and shareholders. The board can adopt restrictive by-laws or ones that impose stringent requirements for shareholder rights. For instance, for proxy access, it may require a 9% threshold or a 5-year holding period. Such private ordering serves the function of diluting the efficacy of shareholder activism by imposing stringent preconditions. Furthermore, it is shown that the boards could adopt defensive mechanisms in the case of shareholder activism. This could dilute the voting power of activist shareholders. Moreover, shareholders still do not have strong participatory rights in director elections. These shortcomings could prevent the meaningful functioning of shareholder activism.

5.4 Conclusion

This chapter demonstrated that US corporate governance is in flux in terms of the power of shareholders and there is a shift towards shareholder empowerment. Traditionally, the courts have provided strong deference to the board of directors through the business judgment rule. The courts justified this strong deference by reference to the ability of shareholders to replace directors. However, this rationale has been challenged by this chapter because shareholders do not possess meaningful power in director elections.

Close scrutiny of the legal and regulatory reforms to date shows that shareholders not only have limited participatory rights but also have been prevented from exercising their existing rights. There have been incremental changes brought by legal reforms and private ordering. Lawmakers and regulators consider increased shareholder activism as a means of ensuring greater director accountability, and favour the shareholder empowerment view and expanded shareholders' participatory rights. The combination of the legal and regulatory reforms, and the increasing use of private orderings demonstrates the emergence of progress towards more shareholder friendly US corporate governance. Shareholders are moving to the centre of corporate governance. However, several aspects of the law limit the ability of shareholders to participate in the process of private ordering and directorial elections. First, the courts provided strong deference the board-adopted by-laws, even the ones that limit shareholder power. In justifying this situation, the courts argued that shareholders also have power to adopt, amend and repeal by-laws. However, this chapter has shown that while the board can restrict shareholder power, shareholders cannot limit the board's adoption of a by-law with which they do not agree. This asymmetry undermines the justification of the strong deference to the board's authority in the context of private orderings. In this respect, the board could reverse shareholder-adopted private orderings to undermine shareholder activism. Furthermore, shareholder proposals are primarily submitted under Rule 14a-8. However, Rule 14a-8 provides the board with strong power to exclude shareholder proposals from proxy materials of the company. These exclusion grounds could be overly used by the board and management to undermine the effectiveness of shareholder activism. Second, with regard to director elections, PVR and the no-access rule undermines the ability of shareholders to nominate directors and to show their dissatisfaction with the current directors. Shareholders have to make changes through private ordering, which is also subject to the aforementioned limitations. In these areas, legal reforms are much needed in order for US corporate governance to accommodate shareholder activism.

Chapter 6. Accommodating Shareholder Activism in the US System of Corporate Governance

6.1 Introduction

The primary aim of this chapter is to discuss whether the director primacy model provided in the US should be softened to accommodate the evolving role of shareholders in US corporate governance. As discussed in Chapter 2, director primacy has been developed in an absolute form and does not welcome shareholders' participation. Chapter 5 also discussed how the courts interpret the board authority under section 141(a) and how shareholder activism has long been impeded on the grounds of anti-empowerment rhetoric as discussed in Chapter 3. Shareholders, who were once excluded from the decision-making of companies, are now increasingly engaged in management and are willing to play an active role in corporate governance. However, tensions between the board and shareholders remain. As such, director primacy recognises a very limited role for the shareholders. These developments raise a fundamental question: whether a new understanding of director primacy is needed to reflect the evolving allocation of powers between shareholders and directors. If so, it is uncertain how the new role of shareholders should be accommodated in the US corporate governance model. Drawing on the analysis in Chapters 3, 4 and 5, a normative claim can be made questioning how or indeed whether the director primacy model should survive in the US.

This first section of this thesis offers an alternative approach whereby the two important of attributes of corporate governance, namely authority and accountability, could be compatible with each other in the context of contemporary shareholder activism. Hence, corporate governance should be built around these core values. Moreover, it argues that it could enhance the independence and monitoring capacity of the board of directors. Pursuant to this line of reasoning, director primacy should not be allowed in such an extreme form and should provide more room for shareholders. The following section analyses the UK corporate governance model, a possible alternative that shows that a board's authority can be compatible with strong shareholder rights. It will be shown that the new role of shareholders is consistent with

Delaware's traditional approach to company law and director primacy. The final section analyses the shareholder-centric policy reforms which aim to increase the functioning of contemporary shareholder activism within the internal structure of public companies. It makes the case for creating a level playing field for private ordering and making director elections more meaningful. At the same time, it argues for the regulation of the role of shareholders in securities law given the potential problems related to shareholder activism discussed in Chapters 3 and 4.

6.2 From a Positive Theory of Contemporary Shareholder Activism to a Normative Claim for the Future Direction of Company Law

The aim of this section is to present a positive theory of shareholder voting which supports a normative claim that director primacy theory should not be allowed to survive in its extreme form described in Chapter 2. Director primacy and shareholder primacy theories often reach normative conclusions by producing empirical evidence and purporting to show that their model is more efficient than the other. However, as seen throughout this thesis, empirical evidence is inconclusive. As Jensen stated:

> '… the reason we have an interest in developing positive theories of the world is so that we can understand how to make things work more efficiently. Without accurate positive theories of cause and effect relationships, normative propositions and decisions based on them will be wrong. Therefore, the two objectives are completely consistent'.[1]

Director primacy and shareholder primacy theories cannot draw consistent and coherent normative conclusions and policy implications from the conflicting empirical evidence. This thesis relies on the cause and effects of contemporary shareholder activism in its many varied forms to draw normative conclusions and tries to avoid the polar characterisations of shareholder activism.

Director primacy theory explains why near-absolute decision-making power should be given to the board of directors: the centralised decision-making authority at the hands of the board of directors addresses decision-making costs such as information, talent, expertise, coordination, collective action problems, and conflicts

[1] Michael Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems' (1993) 48 *The Journal of Finance* 831.

of interest that would be incurred if shareholders managed companies. Thus, centralised management provides the most efficient and effective decision-making mechanism for public companies. Such an understanding is not only embraced by the courts, as discussed in Chapter 5, but is also used to determine the desirability of any legal and regulatory reform. In this framework, the optimal balance of power does not provide much room for shareholder participation in management and the case for corporate reform is primarily ignored. The role of shareholders has been relegated to the side-lines because of the near-absolute interpretation of board authority in this framework. Furthermore, according to director primacy theory, shareholder-friendly governance would be inefficient and value-decreasing because it reduces the board's authority. In this schema, the protection of the board's authority and limiting shareholder intervention are the ultimate goals to which all aspects of corporate governance should be directed. Furthermore, shareholders are assumed to willingly delegate decision-making authority to the board in exchange for specialised management in director primacy theory. However, the theory has difficulty explaining why institutional shareholders submit shareholder proposals to increase their influence in corporate governance. More importantly, it also struggles to account for why the proponents of director primacy theory actively oppose the removal of legal obstacles to shareholder-adopted forms of private ordering if such near-absolute director authority is rational and value-increasing for institutional shareholders. Another weakness of this theory is that the board and other corporate accountability mechanisms are said to be sufficient to hold management accountable. However, Chapter 2 demonstrated that corporate accountability mechanisms are subject to inherent limitations. The board's ability to monitor management is more restricted than is assumed. As discussed in Chapters 2 and 5, independent directors lack the time or sufficient knowledge and expertise about the problems of companies. Moreover, independent directors might be too close to management and too reliant on the information supplied by it. The board could therefore be trapped by management, and more likely to refrain from close monitoring.

The proponents of shareholder primacy theory rely on managerial accountability problems. They conceive the reduction of agency cost problems as the primary target of corporate law and to which all aspects of corporate governance reform should be directed. So they find director primacy theory inefficient and value decreasing. Both sides of the debate have sought to justify their position in empirical terms and have made normative conclusions based on their empirical evidence.[2] As seen throughout this thesis, the empirical evidence is inconclusive and there is no consistent relationship between shareholder empowerment and the financial performance of companies. As discussed in Chapters 3 and 4, shareholder activism is neither good nor bad per se and can be excessive or have a suspect side in which shareholders extract private benefits from activism without bearing the economic consequences of their actions.

Each theory regarding the allocation of power is, therefore, subject to certain shortcomings. What is more in this debate, the concepts of authority and accountability are found to be incompatible with each other. Bainbridge argued that 'they are ultimately antithetical: one cannot have more of one without also having less of the other'[3] and makes the normative claim that 'one must not lightly interfere with the board's decision-making authority in the name of accountability'[4] because it is argued that 'directors cannot be held accountable without undermining their discretionary authority'.[5] Hence, it is assumed that there is an inherent trade-off between authority and accountability.

Contemporary shareholder activism, however, indicates that accountability and authority could function together. Institutional shareholder activism consists of different types of shareholder activism, which differ in terms of motives, business models and targets. In other words, mainstream investors exercise reticent activism and are interested in the way that companies are governed. These developments aim to create constructive engagement with the board and management, and do not lend unconditional support to activist funds. Activist funds conceive activism as an investment strategy, and can adopt confrontational approaches towards the board and

[2] Lucian Bebchuk, 'The Myth That Insulating Boards Serves Longterm Value' (2013) 113 *Columbia Law Review* 1637; Lucian Bebchuk, 'The Myth of the Shareholder Franchise' (2007) 93 *Virgina Law Review* 675.
[3] Stephen Bainbridge *The New Corporate Governance in Theory and Practice* (OUP 2008) 113.
[4] Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' (2003) 97 *Northwestern University Law Review* 547, 573.
[5] Stephen Bainbridge, 'Director v. Shareholder Primacy in the Convergence Debate' (2003) 16 *The Transnational Lawyer* 45, 60.

management. Alternatively, some institutional shareholders can be driven by social and environmental motives. According to Hirschman's framework, shareholder activism is 'any attempt at all to change, rather than to escape from, an objectionable state of affairs, whether through individual or collective petition to the management directly in charge, through appeal to a higher authority with the intention of forcing a change in management, or through various types of actions and protests, including those that are meant to mobilise public opinion'.[6] Therefore, shareholder activism is a means of resolving potential conflicts between shareholders' views and the existing management's strategy through the board of directors. In this regard, the board is the ultimate decision-making authority in public companies. In this context, shareholder activism serves two important functions: challenging the board to change its corporate policy, and engagement with the board. Shareholder activism not only provides monitoring, but also enhances the decision-making capacity of the board of directors. In this aspect, there is no trade-off between shareholder activism and the board's authority as such. This conceptualisation requires us not to think of the allocation of power as a zero-sum game in which authority is transferred from board to shareholders in the name of accountability. In this respect, rather than focussing on who should have the ultimate power in public companies, the goal must be to address accountability problems while maintaining sufficient room for the board to make decisions. This delicate task does not exclude any constituencies from corporate governance and acknowledges the role of shareholders and the economic importance of the board's authority.

Likewise, Moore argues that accountability 'is *not* equivalent, or even tantamount, to the qualitatively distinct notion of decision-maker disempowerment'.[7] Accountability refers to 'the giving and demanding of reasons for conduct'[8] and account means 'a statement made by a social actor to explain unanticipated or

[6] Albert Hirschmann, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States* (Harvard University Press 1970) 30.
[7] Marc Moore, 'The (neglected) Value of Board Accountability' (2015) 9 *Law and Financial Markets Review* 10 11.
[8] John Roberts and Robert Scapens, 'Accounting Systems and Systems of Accountability-Understanding Practices in their Organisational Contexts' (1985) 1 *Accounting, Organisations & Society* 443, 447.

untoward behaviour – whether that behaviour is his own or that of others'.[9] In the context of corporate governance, accountability 'provide[s] normatively cognisable reasons in attempted support of her decisions or conduct, irrespective of whether any such decision or course of conduct is past, present or proposed to be carried out by [a decision-making body] in the future' to the beneficiaries of decisions. The aim of 'compelled reason-giving' is not to extract information from the decision-making body but to obtain a normatively cognisable explanation about the benefits of a decision.[10] In this context, compelled reason-giving enables shareholders to carry out oversight of the decision-making body at low cost. The value of accountability is, therefore, broader than instrumental criteria such as efficiency, cost-benefit analysis, and efficacy, which have been used to justify the desirability of any legal reform or changes. The upshot is that director accountability and authority are not mutually off-setting. On the contrary, they enhance each other.

6.2.1 Locating Shareholder Activism in the Decision-Making Processes of Public Companies

The ultimate authority to manage the company is given to the board of directors. Shareholder activism only brings an element of moderation to the corporate discussion table. In this regard, it functions between the board and management. It plays this role by serving two important functions in listed companies. First, it addresses the deficiencies of the current board structure that limit its ability to monitor management. It challenges the existing corporate strategy and reveals flaws in the governance structure or the business model. In doing so, it brings new information to the board by either formal or informal communication means or by appointing an industry expert. Second, contemporary shareholder activism also includes engagement with the board and management. This collaborative activism enables the board and management to turn mainstream investors against activist funds. In this respect, the heterogeneity of institutional investors plays an important role. Shareholder activism reveals the flaws in the current business model from different perspectives. The board's accountability

[9] Marvin Scott and Stanford Lyman, 'Accounts' (1968) 33 *American Sociological Review* 46, 46.
[10] Moore (n 7) 16.

to shareholders therefore, could still be obtained without rejecting the authority of the board, in contrast to director primacy.[11] So contemporary shareholder activism serves a managerial error correction function rather than exercising decision-making authority. The ultimate decision-making power belongs to the board, and the power imbalance between the board and shareholders continuous. These two aspects will be examined in detail in the following section.

6.2.1.1 Challenging the Board of Directors

The board of directors and management are two distinct institutions of public companies. As noted in Chapters 2 and 5, the oversight role of independent directors is difficult and problematic because they are mostly part-time and often do not have expertise in the relevant field, i.e. they are 'thinly-informed'. This significantly reduces the board's capacity to carry out the managerial and monitoring roles, and undermines the validity of the director primacy theory. Independent directors have little incentive to challenge management due to re-election concerns, the influence of management on the appointment process, and their reliance on the information supplied by management in forming major business strategies or scrutinising business plans proposed by the management. In this respect, activist funds can address an important short-coming of the modern board of directors. As noted in Chapter 2, the boards often fail to challenge and to critically evaluate corporate strategies. This situation plays an important role in corporate governance failures.

Challenging the board is important in the decision-making process because 'insurgency, contention and debate are fundamental to effective corporate governance'.[12] The board has to provide a justification for its current corporate policies. A value creation board should be able to 'balance the following contradictory forces: trust and critical challenge, monitoring and involvement, collaboration and independence'.[13] Corporate failures such as Enron, WorldCom and Tyco showed that

[11] Steven Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 *Vanderbilt Law Review* 83, 109.
[12] John Pound, 'The Rise of The Political Model of Corporate Governance and Corporate Control' (1993) 68 *New York University Law Review* 1003, 1071.
[13] Iris H-Y Chiu *The Foundations and Anatomy of Shareholder Activism* (Hart Publishing 2010) 66.

challenging management could be the most effective way of dealing with managerial inefficiencies.[14] This became evident once again in the 2015 Volkswagen emissions scandal where it is argued that the board was biased towards management and that there was a culture of silence.[15]

Activist funds often voice serious criticisms of the business strategy of the current management. These criticisms are shortcomings of the company according to the activist funds. In the course of activism, they provide new information and alternative business proposals to shareholders and the board, and sometimes nominate business experts as board candidates. More importantly, their nominated directors are not afraid of speaking out against management. Activist funds are information traders and have resources to collect, process and analyse a large volume of information, independently of management. They present this information either directly to the board or through directors nominated by them. For instance, in 2015, General Electric invited Trian, a hedge fund, to purchase shares to help the board in executing and developing new business strategies.[16] This would have been impossible just a few years ago in the US and is a sign of the normalisation of shareholder activism in that jurisdiction.

Once the board encounters information-rich shareholder proposals arguing that the incumbent management is underperforming due to serious strategic mistakes, the board has two options: either to defend the existing model and to ask for support from other investors, or to modify the existing strategy. If the information brought by activist investors to the board improves the performance of the company, it is more valuable than the information provided by the management to the board or vice-versa. In this regard, a novel role for the board emerges: 'it functions as an arbitrator between

[14] Similarly see, Thomas Briggs, 'Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis' (2007) *The Journal of Corporation Law* 684, 720.
[15] Sarah Gordon, 'Emission Scandal Offers Lesson on Need for an Outside View' *Financial Times* (19 May 2016); John Coffee, 'Volkswagen and the Culture of Silence' (*The CLS Blue Sky Blog, 23 May 2016*) http://clsbluesky.law.columbia.edu/2016/05/23/volkswagen-and-the-culture-of-silence/.
[16] David Benoit, 'Activism's Long Road from Corporate Raiding to Banner Year' *The Wall Street Journal* (26 December 2015) < https://www.wsj.com/articles/activisms-long-road-from-corporate-raiding-to-banner-year-1451070910> accessed 20 January 2016.

different stakeholders who wish to take the firm in different directions'.[17] A serious alternative business plan by an activist fund will raise significant questions in the boardroom and between mainstream investors. There is nothing wrong with a choice between the current and alternative business plans presented to the board, and if the board does not accept the alternative proposal, it can present its case to the shareholders. In this case, the counter-move comes from the board and management in order to defend the current business strategy and to maintain their positions. This is where the current model of the board reaches its limitations. Independent directors with limited information about the industry may not provide an answer to the activist funds and cannot be a credible arbitrator in the eyes of mainstream investors. However, the board is still in an advantageous position because it knows the fundamental value of the company better than anyone. The possibility of offensive activism further requires the board to have an ongoing engagement with shareholders to maintain the current business strategy and even their position and slow down the activist funds. The board must provide justifications for their judgment and offer solid grounds to mainstream investors and other activist funds to reject the alternative business plan.

6.2.1.2 Engagement between the Board and Shareholders: A New Paradigm in the US

The screening function of mainstream investors actually depends on the nature of the engagement with the board. The engagement between the board and shareholders is the collaborative aspect of shareholder activism. This aspect of shareholder activism plays a decisive role in the success of activist funds and in the future directions of the company. As discussed in Chapter 3, mainstream institutional shareholders show interest in the development of major business strategies and place importance in ESG and CSR issues, i.e. to exercise responsible shareholder activism, to hold direct engagement with directors and to support business plans to achieve long-term value

[17] Jonathan Cohn and Uday Rajan, 'Optimal Governance in the Presence of an Activist Investor' (2013) 26 *Review of Financial Studies 985,* 986; Bernard Sharfman, 'Activist Hedge Funds in a World of Board Independence : Creators or Destroyers of Long-Term Value ?' (2015) 2015 *Columbia Business Law Review* 813, 847.

creation.[18] It is, however, a new paradigm for US corporate governance.[19] American style activism was mostly proxy activism.[20] Since shareholders had limited means of influencing the board, the boards did not feel any compulsion to address shareholders' voice outside of shareholder meetings. So, the shareholder vote, in particular non-binding shareholder proposals under Rule 14a-8, was mainly regarded as a communication method with the company.[21] Now, even Lipton, who is well-known for assisting companies against shareholder participation and is against shareholder empowerment,[22] now acknowledges that 'some shareholder activism should be encouraged'.[23]

This kind of engagement is essential in the era of investor capitalism, given the fact that even large companies such as Apple, Microsoft, Sony, eBay and PepsiCo have been targeted by activist funds.[24] Boards need to provide normative explanations for their decisions, i.e. justify their business plan against any alternative strategies in

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[18] William McNabb, 'Getting to know you: Sharing practical governance viewpoints' (Speech at University of Delaware John Weinberg Center for Corporate Governance, 30 October 2014) < http://lerner.udel.edu/sites/default/files/WCCG/PDFs/events/Transcript%20_UDel%20Corp%20Governance%2010%2030%202014_%20FINAL%20for%20UD%20website.pdf>; Laurence Fink, 'Letter to the CEOs of S&P 500 Companies' (BlackRock 1 February 2016) < http://www.wlrk.com/docs/CorpGovernanceLetter.pdf> accessed 07 November 2016; Martin Lipton, 'The Spotlight on Boards 2017' (*HLSFCGFR,* 15 November 2016) < https://corpgov.law.harvard.edu/2016/11/15/the-spotlight-on-boards-2017/ > accessed 18 November 2016.

[19] In the US, activism was usually based on individual events, see Yaron Nili, 'Missing the Forest for the Trees: A New Approach to Shareholder Activism' (2014) 4 *HBLR* 157, 182; Martin Lipton, 'A New Paradigm for Corporate Governance' (*HLSFCGFR,* 22 September 2015) < https://corpgov.law.harvard.edu/2015/09/22/a-new-paradigm-for-corporate-governance/ >; Martin Lipton, 'The New Paradigm for Corporate Governance' (*HLSFCGFR* 3 February 2016) https://corpgov.law.harvard.edu/2016/02/03/the-new-paradigm-for-corporate-governance/ ;

[20]; Bernard Black and John Coffee, 'Hail Britannia?: Institutional Investor Behavior under Limited Regulation' (1994) 92(7) *Michigan Law Review* 1997, 2014.

[21] Fisch (n 181) 479.

[22] Martin Lipton and William Savitt, 'The Many Myths of Lucian Bebchuk' (2007) 93 *Virginia Law Review* 733; Martin Lipton, 'Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy' (*HLSFCGFR* 26 February 2013) https://corpgov.law.harvard.edu/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/ accessed 05 November 2016; Shira Ovide, 'Marty Lipton: Why I Invented the Poison Pill' *The Wall Street Journal* (29 December 2010) http://blogs.wsj.com/deals/2010/12/29/marty-lipton-why-i-invented-the-poison-pill/ accessed 06 November 2016.

[23] David Benoit, 'Martin Lipton Names Some Activists He Respects' *The Wall Street Journal* (28 March 2014) https://www.wsj.com/articles/SB10001424052702304688104579467300437514472 accessed 20 January 2017.

[24] Martin Lipton, 'Dealing with Activist Hedge Funds' (*HLSFCGFR* 2 June 2015) < https://corpgov.law.harvard.edu/2015/06/02/dealing-with-activist-hedge-funds-4/ > accessed 08 November 2016.

order to obtain support from mainstream shareholders. Continuing engagement, as a matter of fact, enhances board authority by securing the acquiescence of shareholders with the board's business strategy and substantially decreases the possibility of unilateral agreement on the removal of the board of directors.

Continuing engagement provides a low-cost proxy for detailed oversight by shareholders of the board's decisions and actions, and also reduces the tension between shareholders and management. This interaction enables the board to understand shareholders' concerns about the management of the company and the general structure of governance, rather than announcing their concerns through stock markets when they exit. They can therefore respond to these concerns, either incorporating them into policies or rejecting them with sound reasoning.[25] This enables the board to shape corporate policies that better reflect shareholder interests and preferences, and to be prepared for future issues and potential problems. These concerns are not necessarily related to financial issues or the short-term interests of shareholders. Some of them incorporate ESG issues into their business models, so that they can carry out 'representative bargaining for other stakeholders'[26] along with their own interests and seek change in social policy at portfolio companies. Shareholder engagement, therefore, enriches the board from different perspectives and forces it to be more critical about management.

Engagement creates collaboration between the board, mainstream investors and even activist funds. It enables the board to transmit its explanations to shareholders to be more patient and remove any potential misunderstandings. This allows shareholders to make more informed decisions in future votes. It may help to establish harmony between the shareholder base and the purpose of the firm.

In the case of confrontational forms of activism, this ongoing engagement with shareholders will insulate the board from pressure from activist shareholders. For engagement to be meaningful for the board, shareholders should be able to evaluate the explanations of the board objectively. Mainstream institutional investors are

[25] Lisa Fairfax, 'Mandating Board - Shareholder Engagement' (2013) 2013(3) *University of Illinois Law Review* 822 at 833.
[26] Chiu (n 13) 131.

responsive to proposals by management or activist shareholders; they are passive investors, not passive owners. The question then becomes whether institutional investors other than activist funds can screen the initiatives of activist funds and support the board when needed. A hedge fund manager has said that ‘the big institutional players listen to both sides and are willing to back the activist fund if they believe in them… You can win with persuasion and ideas’.[27] The CEO of Vanguard, a large mutual fund, explained this relationship as:

> ‘The nature of activist investing has changed significantly since the 1980s. Today, we’re seeing a greater trend toward constructive activists rather than destructive activists. Activists are not inherently good or bad … They often raise legitimate questions. And when they raise legitimate questions and tie their business cases to long-term shareholder value—that gets our attention. There have been a number of cases where a board wasn’t asking the right questions and eventually lost touch with how the company was being run, and how it was being perceived by investors’.[28]

When institutional investors are not convinced that the proposals of activist funds enhance shareholder value, they will be less likely to support them. For example, Biglari Holdings Inc., a hedge fund owning almost 20% of Cracker Barrel Old Country Store, proposed that Cracker Barrel should take on a significant amount of debt in order to announce a $20 per share dividend.[29] Other shareholders did not favour short-term returns over long-term interests in the company, and Biglari was defeated. Indeed, this is crucially important because shareholder activism might have a darker side. Some activist funds through wolf-packs, golden leashes and empty voting could undermine the screening capacity because in some cases activist funds can act on their own without the need for a coalition with other shareholders.

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[27] Alexandra Stevenson, ‘No Barbarians at the Gate; Instead, a Force for Change’ *The New York Times* (6 January 2014) < http://dealbook.nytimes.com/2014/01/06/no-barbarians-at-the-gate-instead-a-force-for-change/> quoting Gregory Taxin, president of the Clinton Group and a co-founder of Glass Lewis & Company, the independent research and proxy advisory firm.

[28] William McNabb, ‘Getting to know you: Sharing practical governance viewpoints’ (Speech at University of Delaware John Weinberg Center for Corporate Governance, 30 October 2014) < http://lerner.udel.edu/sites/default/files/WCCG/PDFs/events/Transcript%20_UDel%20Corp%20Governance%2010%2030%202014_%20FINAL%20for%20UD%20website.pdf>.

[29] Morrison & Foerster, ‘Cracker Barrel Old Country Stores, Inc. and Biglari Holdings Inc.: Chronology of Events Surrounding Proxy Contest for Board Representation, *Unsolicited Views* (2014) http://media.mofo.com/files/Uploads/Images/UV-Cracker-Barrell-Biglari-Holdings.pdf.

6.2.2 Concluding Remarks

Managerial accountability does not come at the expense of the board's authority or vice versa. These two concepts sustain each other. It is possible to address accountability concerns while preserving sufficient discretionary room for directors. Director primacy therefore should not survive in its extreme form which does not accept even light interference. A softer version of director primacy, which is open to shareholder voice, should prevail because it can address both the decision-making costs of large companies and the accountability problems faced by those companies. This version of director primacy aims to address managerial accountability more effectively and to enhance decision-making processes of public companies while preserving the board's discretionary powers to make necessary decisions. Legal reforms should therefore not aim to shut down shareholder activism, as the critical views it brings from different perspectives about the financial and non-financial performance of the company are beneficial.

The board's role could become one similar to that of an arbitrator between an activist fund and the incumbent management. This would require the board to be objective and to be more critical about management proposals. In other words, the board would still be the supreme decision-making authority in corporate governance, but it would have to account for its decisions and actions to maintain the current business strategy and its position, and to prevent further escalation of shareholder activism. This requires continuing engagement between mainstream investors and shareholders.

Contemporary shareholder activism makes an attenuated form of director primacy possible. It plays a crucial role in reducing the influence of management over the board. It collects new information and provides it to the boardroom either through communication means or the appointment of new directors. Shareholder activism not only serves a monitoring role but also enhances decision-making authority. In doing so, it ensures the independence of the board from management. The board finally becomes truly independent of management and more critical of management as a result of shareholder activism. In this respect, it could function more effectively in its role as envisaged by director primacy theory.

6.3 Board Authority is Compatible with Strong Shareholder Rights

The UK's corporate governance model is one of the most shareholder friendly legal frameworks in the world.[30] Shareholder participation has been comparatively uncontroversial in the UK[31] while the value of the board is recognised and protected by the courts and shareholders. A scholar who favours director primacy as described in Chapters 2 and 5 might imagine that the board of directors plays a limited role or that the board is vulnerable to shareholder pressures.[32] However, this does not reflect the reality of UK corporate governance which recognises the role of three main actors: shareholders, directors and managers. Rather than discussing the ultimate control of shareholders, it recognises the private negotiations and the market realities that constitute the foundations of corporate governance. As will be seen, the board is overwhelmingly accorded ultimate decision-making powers by shareholders. This shows the market and economic factors have influence over shareholders. UK corporate governance reflects a combination of positive law, market realities and a set of private orderings that recognise economic necessity and the value of centralised management.

6.3.1 Board Authority in the UK

Authority is not statutorily allocated in the UK. UK company law considers the division of power between the board of directors and shareholders a contractual matter which should be laid down in the articles of association. In the absence of specific regulations in the articles of association, the Model Articles (default articles of association) apply unless excluded by the shareholders.[33] Most companies apply the Model Articles.[34] With this in mind, the Model Articles and case law will be used to examine the board's authority for decision-making in the UK. Article 3 of the Model

[30] See Chapter 5; Lynn Stout, *The Shareholder Value Myth* (Berrett-Koehler Publishers 2012) 56; Luca Enriques, Henry Hansmann, and Reiner Kraakman 'The Basic Governance Structure: The Interests of Shareholders as a Class' in Kraakman et al. (eds) *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2009) 29.
[31] Marc Moore, *Corporate Governance in the Shadow of the State* (Hart, 2013) 187.
[32] Alan Dignam, 'The Future of Shareholder Democracy in the Shadow of the Financial Crisis' (2013) 639 *Seattle Law Review* 639.
[33] Most companies apply the model articles of association. See Dignam (n 38) 660.
[34] Dignam (n 32) 660.

Articles confers a broad range of powers on the board. The board of directors is the primary and default organ for the management of the company. The efficiency arguments relating to centralised decision-making authority are therefore also fully acknowledged by UK shareholders. The board of directors is the ultimate decision-making body in the UK.[35] The decision-making primacy of the board is a result of private ordering. Shareholders do not attempt to consolidate power in their hands and recognise the economic costs of decision-making in public companies.

Since the board's authority is a result of private orderings, it is important to understand how it is protected by the courts and the extent to which the board can exercise its power. In principle, UK law does not have a rule similar to the US business judgment rule. However, similar judicial reluctance to second-guess business judgements and particular managerial decisions serves a similar normative effect in UK corporate governance. In public companies, bona fide decisions of the board of directors concerning a broad range of subjects including charitable, political and educational spending have been traditionally protected by the courts as long as decisions are related overall to the advancement of the company's business.[36] Striking a balance between the board's authority and accountability to shareholders has not been a straightforward task for the courts. The core question has been whether the board of directors is able to take decisions against the wishes of shareholders.

At the beginning of the twentieth century, the UK courts stopped equating shareholders with the company and recognised directors as the company' agents in *Automatic Self-Cleansing Filter Syndicate Co Ltd v. Cunninghame.*[37] The court decided that the power given to the board could be exercised by them and that shareholders have no power to interfere with their discretion. In another decision, the court denied that directors are agents of and bound to serve shareholders and accepted that the company can be the only principal of the directors.[38] The modern doctrine on

[35] Paul Davies and Sarah Worthington, *Gower's Principles of Modern Company Law* (10th edition, Sweet&Maxwell 2016) 355.
[36] Moore (n 31) 150.
[37] *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch. 34, CA.
[38] *Gramophone and Typewriter v Stanley* [1908] 2 KB 89 at 106; Likewise, the decisions of a general meeting instructing the board to distribute an interim dividend were found to be invalid by the court. *Scott v Scott* [1943] 1 All E.R. 582.

the legal effect of the articles of association on the division of power between shareholders and directors is found in *Shaw & Sons (Salford) Ltd v. Shaw*[39] and was reiterated in *Howard Smith Ltd v. Ampol Petroleum Ltd*:

> 'Just as it is established that directors, within their management powers, may take decisions against the wishes of the majority of shareholders, and indeed that the majority of shareholders cannot control them in the exercise of these powers while they remain in office.'[40]

It seems clear that where the default regime is applied, common law protects and respects the authority of the board of directors. It is difficult to deduce that the board is vulnerable to activist shareholders as a result of the allocation of power between shareholders and directors. However, it is still possible that the authority of the board could be constrained by a special resolution directing the directors what to do,[41] but in practice, it will be very difficult given the dispersed share ownership of UK public companies because special resolutions require a 75 % of the votes cast by the shareholders.[42]

The manner in which directors are allowed to exercise their powers can also constitute a limitation upon their discretion. The authority of the board of directors is subject to the general duties of directors to ensure that the delegated power is not misused. The general formulation of directors' duties does not confer any obligation to focus merely on shareholders' interests. Rather, section 170 clearly sets out that the duties are owed to the company. Section 172 mandates a director to act 'in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard' to stakeholders' concerns. If the shareholders' interests are equated with the interests of the company, the result may be an inconsistent situation in which, on the one hand, the company is a separate legal entity from its shareholders and, on the other hand, its substance is the interests of shareholders. Dignam argues that if directors are indirectly obliged to

[39] *Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 K.B. 113, CA.
[40] *Howard Smith Ltd. v. Ampol Petroleum* [1974] A.C. 821, 837; see also *Quin & Axtens v Salmon* [1909] 1 Ch. 311, CA; *Breckland Group Holdings Ltd v London & Suffolk Properties Ltd & Ors* [1988] 4 BCC 542, [Ch].
[41] See Article 4(1) of the Model Articles.
[42] Section 283 of the Companies Act 2006.

pursue the interests of shareholders, it is questionable to what extent they can take action against the shareholders' demands and that they would violate their duties if they acted against the interests of shareholders.[43] In this case, he further legitimately asks, 'what exactly are the directors for if no real delegation of power takes place?'[44]

The scope of authority, therefore, is also based on an interpretation of the interests of the company. The difficulty is that the company is an artificial legal entity and its interests are often identified by reference to its shareholders. In some cases, the judiciary have adopted a narrow approach in which they have recognised the shareholders as the substance of the company. In other cases, they have applied a broader approach where the board has delegated power and uses its power for proper purposes.

The courts are also aware of the danger that strict adherence to a narrow approach could undermine the authority of the board. The courts solve this problem by adopting a broader approach when the board exercises power for the proper purposes.

First, the courts have made a distinction between 'current' shareholders and 'future' shareholders.[45] The courts acknowledge that the interests of the company cannot be determined without including current and future shareholders within the concept of the company as a whole.[46] The emphasis on the future interests of shareholders within the interests of the company highlights the point that shareholders' interests are also related to the company's long-term performance, because the interests of future shareholders depend on investment in R&D projects, the reputation of the company on ESG issues, and training programmes for employees. The interests of shareholders therefore involves both the immediate and long-term performance of companies. Indeed, this distinction is required because, as seen in Chapter 4, the shareholder base of a listed company consists of different types of shareholders and

[43] Dignam (n 32) 663.
[44] Dignam (n 32) 663.
[45] *Gaiman and Others v National Association for Mental Health* [1971] Ch. 317, 329.
[46] See *Gaiman and others* (n 45).

there is no one single or typical interest of the shareholders. It also implies that there are a variety of interpretations of the interests of shareholders.

The courts have interpreted the concept of the interests of the company broadly to embrace some stakeholder concerns and this, in turn, expands the board's authority. The early and often-quoted example is the *Hutton v. West Cork Railway Co.* case in which, while acknowledging the significance of shareholders' interests, there were early signs of stakeholder concerns that could be incorporated into the decision-making of directors. Lord Justice Bowen stated that:

> 'The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company … liberal dealing with servants eases the friction between masters and servants, and is, in the end, a benefit to the company.'[47]

This broad understanding of the interests of the company is even more evident in *Evans v Brunner Mond & Co.*[48] The court held that a company can make donations to universities for educational purposes even if there is no expectation of an immediate and direct return to the company. The *Fulham Football Club v. Cabra Estates* case supports this understanding: 'the duties owed by the directors are to the company and the company is more than just the sum total of its members'.[49]

This shows that the courts tend to broaden the scope of the concept of the 'company as a whole' and indirectly the authority of the board. This inclusive understanding is now found in Section 172. This establishes the concept of Enlightened Shareholder Value (ESV) by imposing a duty on directors to 'promote the success of the company for the benefit of its members as a whole, and in doing so have regard' to the concerns of stakeholders in discharging the duty. Some have considered that, with ESV 'UK corporations are moving towards a more stakeholder model of governance'.[50] Others argued that ESV is an emerging third way between

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[47] *Hutton v. West Cork Ry. Co.*, [1883] 23 Ch.D. 654, 672–73
[48] *Evans v. Brunner Mond & Co.*, [1921] 1 Ch. 359.
[49] *Fulham Football Club Ltd & Ors v Cabra Estates plc* [1992] B.C.C. 863, 876 [CA].
[50] Alissa Mickels, 'Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the US and Europe' (2009) 32 *Hasting International and Comparative Law Review* 271, 293.

the shareholder primacy model and the stakeholder model.[51] However, many consider that ESV is little different from common law, which has long required directors to act in the best interest of companies for the benefit of members, including current and future shareholders, and allowed directors to consider interests of other stakeholders as long as it was done for the benefit of the company.[52] It is also argued that ESV does not bring any material change in the objectives of UK companies because directors may have regard the interests of stakeholders when their action most likely promotes the success of the company for the benefits of members as a whole.[53] This thesis will not go into the details of the discussion over whether ESV represents a significant change in UK company law or not, but it is clear that directors have discretionary power to consider the long-term consequences of their actions, which may be at odds with the wishes of current shareholders and short-term interests of some shareholders.

This common law interpretation by the courts is significant for the authority of directors because it expands the scope of the board's power by allowing the board to justify their actions with reference to the success of the company even if it is against the wishes of current shareholders. The courts acknowledge the fact that directors owe fiduciary duties to the company and that the interests of the company could be different from those of shareholders and should not be sacrificed for a group of shareholders.[54] From a legal point of view, directors are not required to maximise the short-term profits of the company at the expense of its long-term success. In short, once the authority is used for proper purposes, the board has a licence to take difficult decisions within the scope of its delegated power.

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[51] Cynthia Williams and John Conley, 'An Emerging Third Way – The Erosion of the Anglo-American Shareholder Value Construct' (2005) 38 *Cornell International Law Journal* 493, 500; Sarah Kiarie, 'At Crossroads: Shareholder Value, Stakeholder Value, and Enlightened Shareholder Value: Which Road Should the United Kingdom Take?' (2006) 17 *International Company and Commercial Law* 329, 339.

[52] Andrew Keay, 'Tackling the Issue of Corporate Objective: An Analysis of the United Kingdom's 'Enlightened Shareholder Value Approach' (2007) 29 *Sydney Law Review* 577; Richard Williams, 'Enlightened Shareholder Value in UK Company Law' (2012) 35 *UNSW Law Journal* 360; see also Shuangge Wen, *Shareholder Primacy and Corporate Governance* (Routledge 2013) Chapter 5.

[53] Keay, (n 52) 592.

[54] *Re a Company (No.004415 of 1996)* [1997] 1 B.C.L.C. 479, 491 (Ch); *Re BSB Holdings Ltd (No 2)* [1996] 1 BCLC 155, 251 (Ch).

When the board uses its delegated powers for what appears to be improper purposes, then their actions are subject to judicial scrutiny. The directors are not allowed to exercise their authority as they wish.[55] In the *Howard Smith v. Ampol* decision discussed above, after emphasising the importance of the independent discretion of the board, the court held that the issue of shares to thwart a takeover bid was not a proper use of the delegated power because the power had been provided to raise capital. This decision shows that when the power is delegated for a specific purpose, it must be used for this purpose, rather than with the aim of protecting the board or management.[56] The authority of the board in the context of takeovers of public companies was further restricted by the establishment of the Panel on Takeovers and Mergers in 1968, as discussed below.

At first glance, it may be reasonable to conclude that the board has no substantial power and cannot make decisions against the wishes of shareholders. In practice, the board is granted a broad range of powers. The CA 2006 and case law do not lend any support to the idea that shareholders are entitled to force the board to focus only on their interests. The board's discretion is further expanded and protected by the courts and statutory duties that incorporate the current and future shareholders' interests and various stakeholders' interests into the interests of the company. Therefore, it is fair to conclude that, even one of the most shareholder friendly jurisdictions does not unequivocally embrace a pure form of shareholder primacy.

6.3.2 The Role of Strong Shareholder Participatory Rights

The board's authority is well-protected and respected by UK company law. At the same time, shareholders possess strong governance and control rights. As will be seen, UK company law is relatively generous compared to US company law at providing formal participatory rights within the scope of corporate decision-making. These rights might appear to be inconsistent with centralised decision-making, but their role

[55] *Hogg v Crampborn* [1967] Ch. 254.

[56] Shuangge Wen, 'The Magnitude of Shareholder Value as the Overriding Objective in the United Kingdom--The Post-Crisis Perspective' (2011) 26 *Journal of International Banking Law & Regulation* 325, 329. There is some dissent regarding the strict application of the proper purpose doctrine. The court did not eliminate the possibility that the proper use of authority may include the issue of shares to discourage a takeover bid. See *Criterion Properties Plc v Stratford UK Properties LLC* [2003] B.C.L.C 129 (CA).

is limited to accountability. The board's authority is consistent with strong participatory rights.

In the UK, shareholders are entitled to proactively add items to the agenda of the general meeting. Sections 338 and 338A of CA 2006 allow shareholders to add an item and a new matter to the agenda of the AGM. Under these sections, shareholders owning at least 5% of the voting rights who are entitled to vote, or 100 members with at least a paid-up average sum of more than £100 can ask the company to add their resolution or new matters to be reviewed at the meeting. Any shareholder resolution or the request to add an item must be included in the proxy card which is usually distributed to all shareholders in advance of the general meeting.[57] Shareholder proposals are in principle legally binding on the board of directors; thus, they are more coercive than their equivalents submitted under Rule 14a-8 in the US. However, rights to add items to the agenda of the annual general meeting in the UK have limitations as well. Under section 338, the board has the right not to circulate the resolution if it is frivolous or vexatious or would be ineffective because of some inconsistency with the law or the company's constitution.

This strong right to add items to the agenda has been rarely used by shareholders.[58] Buchanan et al. reached a similar conclusion that proposals initiated by management are significantly greater in number than shareholders' resolutions in the UK.[59] For example, in 2007, shareholder proposals constituted only 0.2% (a total 5 shareholder proposals) of the total submitted proposals (2,776) at FTSE 250

[57] Under sections 338(4)(d) and 338A(5), the requisition of the notice of resolution and new matters have to be received six weeks before the AGM or before the notice of the AGM is sent by the company. Moreover, the time limitations in sections 340 and 340A also substantially dilute the value of the circulation of proposals and other documents free of charge. These documents can be distributed at the expense of the company only if shareholders submit their resolutions or the matters at least six months before the AGMs.
[58] Stapledon (n 83) 85.
[59] Bonnie Buchanan et al., 'Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom' (2012) 49 *American Business Law Journal* 739.

companies[60] and this low level of proposals submitted by shareholders continues.[61] Despite the shareholder friendly legal framework in the UK, shareholder activism through proposals has not been a prominent aspect of UK general meetings compared to US general meetings.[62] Management proposals are rarely rejected in the UK. In 2015, within the FTSE 250, only three management-proposed resolutions were rejected by shareholders.[63] Glass Lewis' Proxy Report of 2015 is in line with these results.[64]

The right to remove directors is one of the most coercive powers possessed by shareholders. This marks a crucial distinction between UK company law and its US counterpart. It can be argued that the right to remove a director by an ordinary resolution significantly restrains the discretionary power of the board and provides a strong degree of bargaining power for shareholders.[65] Admittedly, as a practical matter, there is however one formal and one behavioural limitation that restrict the ability of shareholders to remove directors, and it will be shown that shareholders can remove directors in the case of serious misconduct rather than for arbitrary reasons. First, under section 168(5), a director cannot be deprived of any claim for compensation in the event of termination. The resolution removing a director may oblige the company to pay a substantial amount of compensation if section 168 is triggered without any reasons – other than for serious misconduct. This can be prohibitive for shareholders unless there are solid reasons to remove directors. The second limitation comes from coordination problems and the market culture of the UK. As noted in Chapter 4, institutional shareholders are now the dominant players in the market. However, they need to form a coalition to remove the board of directors

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[60] Georgeson, 'Proxy Voting Season Review 2007' http://www.georgeson.com/uk/Documents/research/Proxy%20Voting%202007%20%E2%80%93%20A%20Pan-European%20Perspective.pdf.

[61] Peter Cziraki et al., 'Shareholder Activism Through Proxy Proposals: The European Perspective' in William Bratton and Joseph McCahery (eds) *Institutional Investor Activism* (OUP 2015) 105.

[62] Luc Renneboog and Peter Szilagyi, 'Shareholder Engagement at European General Meetings' in Massimo Belcredi and Guido Ferrarini (eds), *Boards and Shareholders in European Listed Companies* (Cambridge University Press 2013) 327.

[63] Georgeson, *Proxy Season Review 2015* (2015) at 10 file:///C:/Users/s1270620/Downloads/Georgeson%20proxy%20voting%20UK%202015.pdf accessed 23 July 2016.

[64] Glass Lewis *2015 Proxy Season Highlights in the UK* (2015) < http://www.glasslewis.com/wp-content/uploads/2016/03/UK-Proxy-Season-Highlights.pdf> acceseed 25 July 2016.

[65] See Dignam (n 32) 660.

or management.[66] Such coalitions are indeed formed in practice, but rarely, and only on an ad hoc basis.[67] The actual use of the right to remove directors manifests itself in extreme cases of corporate mismanagement.[68] The removal of management takes place when its lack of ability becomes evident or there is no doubt that the company's management is in error. Until this point, institutional shareholders usually maintain a dialogue with the existing board and management.[69]

Shareholders have proxy access regarding the board's election far more than their counterparts in the US.[70] The Companies Act 2006 is almost silent about the appointment of directors[71] and according to Article 20 of the Model Articles for Public Companies, the general meeting has the power to appoint a director by an ordinary resolution which is adopted by a simple majority.[72] In practice, the board usually prepares a list of proposed board-level candidates for the shareholders to appoint. It does not often lead to contested elections in listed companies.[73]

While compulsory say on pay regulation is a recent development in the UK, advisory say on pay regulation has been in force since 2002.[74] Directors are required to product two reports: a backward-looking annual report (advisory) and a forward-looking remuneration policy (binding at least every three years).[75] The first report is related to the implementation of remuneration policy reports and is subject to an advisory vote of the shareholders every year. The empirical evidence regarding the effectiveness of say on pay regulation is conflicting. Some empirical evidence

66 Bernard Black and John Coffee (n 20), 2044.
67 Black and Coffee (n 20) 2044-6.
68 Rafel Crespi and Luc Renneboog, 'Is (Institutional) Shareholder Activism New? Evidence from UK Shareholder Coalitions in the Pre-Cadbury Era' (2010) 18(4) *Corporate Governance: An International Review* 274.
69 Geof Stapledon *Institutional Shareholders and Corporate Governance* (Clarendon Press 1996) 123.
70 Moore (n 36) 188.
71 Len Sealy and Sarah Worthington, *Sealy's Cases and Materials in Company Law* (9th edition, OUP, 2010), 265.
72 Section 282 of CA 2006.
73 Brian Cheffins, *Company Law: Theory, Structure, and Operation* (OUP, 1997) 98.
74 Jeffrey Gordon, '"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In' (2009) 46 *Harvard Journal on Legislation* 323, 324.
75 Sections 420, 439 and 439A of the CA 2006.

suggests that the regulation has had no substantial impact on executive pay growth.[76] Nevertheless, it might have, 'a moderating effect on the level of CEO compensation only conditional upon poor performance'.[77] Despite this inconclusive empirical evidence on the link between say on pay regulation and the level of executive remuneration, (see Chapter 3), the UK Government is considering increasing shareholder power and enhancing shareholder engagement in the executive remuneration framework,[78] imposing stronger consequences for companies that encountering significant shareholder dissent over executive pay. It has invited the FRC to revise the UK Corporate Governance Code to lay out actions that companies should take when they face significant shareholder opposition in this area such that even if a majority of shareholders do not oppose executive pay, the objection of a significant minority will oblige companies to revise their executive remuneration structures. Shareholder activism will thus become more meaningful in the UK executive pay framework.

Shareholders' voice extends to takeovers as well. Takeovers are regulated through The City Code on Takeovers and Mergers (the Takeover Code).[79] The code aims to ensure the fairness and efficiency of takeover bids from the perspective of a target company's shareholders. The primary means established by the Code is the board's passivity or 'no-frustration' rule.[80] The UK legal framework is very prohibitive of employing anti-takeover tactics without the consent of shareholders. It considers the takeover to be a transaction between the bidder and the shareholders of the target company. The board of directors, in principle, does not have legitimate grounds to intervene directly. The core tenet of the UK takeover regulations is that the future of the target corporation rests only with its shareholders.

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[76] Fabrizio Ferri and David A. Maber 'Say on Pay Votes and CEO Compensation: Evidence from the UK' (2013) 17 *Review of Finance* 527 528 (emphasis added).
[77] Ferri and Maber (n 76) 530.
[78] Department for Business, Energy & Industrial Strategy, *The Government Response to the Green Paper Consultation* (August 2017).
[79] In the UK, in particular institutional shareholders played a pivotal role in the development of the Takeover Code in order to avoid *ex-post* litigation. See John Armour and David A. Skeel 'Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation' (2007) 95 *The Georgetown Law Journal* 1727, 1731.
[80] Rule 21 of the Takeover Code.

It may appear that the board has not been given authority in the context of takeovers and the takeover rules are strikingly shareholder orientated. However, the board holds indirect power to prevent a hostile takeover by advising the target shareholders.[81] This view of the board's influence is based not just on theoretical grounds, but also by some empirical research.[82] The Panel recently added a new section to the notes explaining Rule 25.2. This sets out that the board can take into consideration the financial merits of the offer, as well as other relevant factors, and the bid price is not the only factor to be considered in providing an opinion from the board. In the context of section 172 of the CA 2006, the general duties of directors, the new interpretative notes to the Rule 25.2 and general principle 3 of the Takeover Code, the board of directors has broad discretion and can consider a range of issues from the financial merits of the bid to the sustainability of the company in forming its opinion of the bid. Directors, therefore, do play a role in the context of takeovers, albeit indirectly.

The preceding examination of the decision-making powers of shareholders indicates that such participatory rights constitute a significant part of UK corporate governance. A further distinctive feature of UK corporate governance is the statutory anti-dilution rights that protect the voting power of existing shareholders. In the UK, institutional investors have traditionally placed special emphasis on anti-dilution rights because they have the practical effect of limiting the scope of management to disempower shareholders in the UK.[83] Institutional shareholders retain the power to permit the board to issue shares in future without specific shareholder approval. Under article 43 of the Model Articles for Public Companies: 'without prejudice to the rights attached to any existing share, the company may issue shares with such rights or restrictions as may be determined by ordinary resolution'. It shows that where the board needs to take action as a result of the financial needs of a company, the board can override the procedural requirements and decide on the issuance of new shares.

[81] Georgina Tsagas, 'A Long-Term Vision for UK Firms? Revisiting the Target Director's Advisory Role since the Takeover of Cadbury's Plc' (2014) 14 *Journal of Corporate Law Studies* 241.
[82] Blanaid Clarke 'Reinforcing the Market for Corporate Control' (2010) *UCD Working Papers in Law, Criminology & Socio-Legal Studies Research Paper No 39/2010*, 11.
[83] Geof Stapledon *Institutional Shareholders and Corporate Governance* (Clarendon Press 1996) 56; see now Parag. 9.3.11. of the Listing Rules and section 551 of the CA 2006.

This demonstrates that shareholders' approval is not required when the board might need to act immediately. Anti-dilution rights force the board and management to establish a dialogue with shareholders in which the company's officers and senior executives develop reasons for the request for the authorisation.

Shareholders are provided strong governance and control rights in the UK. These rights are not frequently invoked in practice, at least not to the extent that the board's authority is significantly diminished. The rights are not used to intrude into the boards' prerogatives. They primarily engender an ongoing account-giving to shareholders. In addition, they provide a formal forum to discuss the fundamental and controversial issues related to the company.[84] The board must provide a reasoned account for their actions and decisions such as the issuance of shares or the refusal of a takeover bid. Such reasoned account-giving is internalised in corporate governance through strong shareholder rights. The existence of such rights not only requires effective and ongoing account-giving at shareholder meetings, but also outside of shareholder meetings. In other words, it forces the board to develop engagement mechanisms with shareholders. In this respect, the rights bring moderation to the power imbalance between shareholders and directors arising from the legal framework and the economic needs of public companies.[85] UK company law combines the board's authority with strong shareholder rights. It demonstrates that the board's authority can be consistent with strong participatory shareholder rights.

6.4 Regulatory Implications of the New Investor Paradigm

Strong shareholder rights are not found to be inconsistent with the board's authority. The present analysis finds that contemporary shareholder activism is compatible with a softer version of director primacy theory. Contemporary shareholder activism is highly complex. On the one hand, activist investors have become one of the foremost players in corporate governance over the last two decades and are not afraid of exercising confrontational activism. They play an important role in revealing managerial divergence from shareholder wealth maximisation, ensuring the independence of the board and stimulating other institutional shareholders. On the

[84] Moore (n 31) 258.
[85] Moore (n 31) 258.

other hand, mainstream institutional shareholders are developing long-term collaborative engagements with the boards. There are growing policy developments, i.e. a new paradigm and the stewardship principles, that recognise public interest concerns and short-term pressures from activist funds. These developments seek to modify shareholders' behaviour. In the context of these policy developments, shareholders are expected to carry out a monitoring role to promote their interests and to provide an accountability mechanism for the sustainability of portfolio companies, the economy and society in general. As a result, this thesis is of the view that shareholder activism in its varied forms has the potential to benefit companies, other shareholders and the market despite the possibility of activist funds having a darker side. Overall, shareholder activism has significant potential to play a preventative role in corporate governance and to address accountability problems in public companies.

This investor paradigm is at odds with US corporate governance. Since shareholders are willing to engage in corporate management and shareholder activism is not inherently detrimental to corporate governance, we should abandon the belief that company law should be built on shareholders as rationally apathetic and that shareholder participation is inherently detrimental to corporate governance. Chapter 5 has demonstrated that while US corporate governance is becoming more shareholder friendly, it still maintains aspects that cause unnecessary tension between the board, management and shareholders. The courts and company law overregulate shareholders' proposals. In contrast to company law, the US's disclosure regime provides one of the most fertile disclosure environments in which to engage in controversial tactics. The disclosure regime, therefore, underregulates shareholder activism to the extent that it allows activist funds to employ wolf-packs and risk-decoupling techniques.

Overall, US corporate governance should accommodate shareholder activism into the functioning of public companies and reform should not focus on neutralising activist funds or the efforts of mainstream investors in corporate governance. In this respect, it could deal with agency cost and accountability problems more effectively than the traditional director primacy theory, and public companies would have better decision-making processes. Regulatory and legal reforms discussed in Chapter 5 played a significant role in enhancing shareholders' voice in US corporate governance, but they fail to accommodate the investor paradigm into US corporate governance and to control the possible side effects of activist funds. In order to accommodate the investor paradigm, i.e. the emergence of activist funds and the awakening of mainstream institutional shareholders into US corporate governance, possible changes in corporate governance and regulatory rules in relation to private ordering, director elections and disclosure rules governing activist funds will be reconsidered below.

6.4.1 The Case for Creating a Level Playing Field for Private Ordering

6.4.1.1 Private Ordering under State Law

Shareholders in the US have the authority to unilaterally adopt, amend and repeal by-laws, which is one of the few direct powers shareholders have. In this respect, by-laws are one of the most important tools with which shareholders can make changes to the internal structure of corporate governance in order to increase managerial accountability and engage in the decision-making process. Like shareholders, directors also possess the authority to unilaterally adopt, amend and repeal by-laws. It is not uncommon for directors to adopt different mechanisms to limit shareholders' power or to impose procedures or higher requirements to the exercise of shareholders' rights.[86] Chapter 5 has demonstrated the different treatment of shareholder-adopted and board-adopted by-laws. The divergent courts' decisions become even more puzzling when the responses to Delaware's legislature are considered.[87] There is a compelling need for coherent and consistent approaches to by-laws.

The judicial deference to the board arises from the recursive loop between sections 109(b) and 141(a) of the DGCL and the courts' strong commitment to the preservation of the near-absolute authority of the board. Board-adopted by-laws are subject to more limited judicial oversight, compared to shareholder-adopted by-laws. Directors are given broad powers, which may allow directors to adopt creative and self-interested by-laws. Obvious examples are poison pills that target activist funds and mainstream investors, or the fee-shifting by-laws discussed in Chapter 5. In this

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[86] Jill Fisch, 'The New Governance and the Challenge of Litigation Bylaws' (2015) 81 *Brooklyn Law Review* 1637, 1638.
[87] See, Chapter 5.

regard, the board and management could adopt restrictive by-laws to insulate themselves from accountability or to limit shareholder activism.

The value and function of shareholder-adopted by-laws are, however, poorly understood by the courts. Shareholder activism could play a corrective function and enhance decision-making without limiting the scope of managerial authority of the board over corporate policy and affairs. By-laws are not necessarily related to shareholder empowerment. They could be related to public interest concerns such as short-termism in the market or ESG issues. They could also be used to adjust the level or type of shareholder activism. Chapter 3 demonstrated that shareholder activism benefits companies depending on a myriad of factors such as the features of the industry in which the company operates and the size of the company. It was further concluded that while activism could be beneficial for some companies, it could be excessive for others. By-laws allow shareholders seeking to maximise the benefits of activism to experiment to establish an optimal structure for particular features of companies and markets. Therefore, this thesis favours private ordering because at least in theory it allows shareholders and directors to shape governance rules according to particular circumstances and to abolish value-reducing decision-making processes and governance practices of the board and management. In doing so, shareholder activism generates new information to companies, directors and capital markets. The upshot is that shareholder-adopted by-laws, within reasonable limits, are important tools for shareholders to protect themselves from board opportunism, to remove value-reducing structures and to establish the optimal governance structure according to the needs of the company.

The current legal framework restricts shareholder participation in decision-making, which almost creates a one-size-fits-all situation in terms of shareholder activism. The current situation does not adequately address the range of needs of different companies. As noted above, different companies obtain diverse benefits from varying degrees of shareholder activism. By-laws could allow shareholders to modify the governance rules of companies according to the most useful model of activism for the company. The limitation on shareholders' ability to adopt private ordering arises from the recursive loop between sections 109(b) and 141(a), and near-absolute understanding of the board's authority. Most importantly, the courts concluded that any shareholder-adopted by-law would be invalid if it placed restrictions on 'the board's management prerogatives under section 141(a)'.[88] The court further provided two important guiding principles: by-laws could only be designed to address procedural issues rather than to mandate substantive issues, and by-laws must not cause directors to violate Delaware law. This approach is problematic from the perspective of contemporary shareholder activism because any by-law could be regarded as intruding impermissibly upon the board's discretionary power.

As argued above, shareholder activism does not necessarily come at the expense of the board's authority. In a similar vein, courts should not consider it as a zero-sum game between shareholder by-law powers and the board's discretionary powers. Put differently, the purpose of a by-law could be to address managerial accountability problems or ensuring an ESG issue is addressed without mandating board action. By-laws are usually defensive in nature and do not impose a specific course of action on the board.[89] They regulate the ways ex ante in which the board's discretionary power is exercised. This does not necessarily mean excessive intrusion on the board's authority.[90] The law should provide enough room for shareholders to adopt by-laws to limit inefficient structures of corporate governance and to modify internal governance rules. These by-laws should not be controlling and should support the functionality of the board of directors. Therefore, the reasonable scope of permissible by-laws should be identified clearly.

In our view, the criteria based on substance or procedures fail to provide a coherent framework for deciding whether a by-law infringes the board's authority under section 141(a). Such a taxonomy is too restrictive because any by-law could be interpreted as being related to substantive issues and intruding on the board's authority. Moreover, it is problematic in light of the description of by-laws under section 109(b). A by-law should be interpreted broadly unless it mandates a particular

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[88] *CA, Inc. v. AFSCME Emp. Pension Plan,* 953 A. 2d 227, 232 (Del 2008).

[89] See, Ben Walther, 'Bylaw Governance' (2015) 20 *Fordham Journal of Corporate Law and Financial Law* 400, 426.

[90] See, Gordon Smith, Matthew Wright, and Marcus Hintze, 'Private Ordering with Shareholder Bylaws' 80 *Fordham Law Review* 125, 143 and 152.

action or decision because a by-law could be related to a general policy of a company. Therefore, controlling by-laws are the ones that do not leave discretion to the board.[91]

So far, this thesis has revealed the inconsistent approach of the courts towards shareholder-adopted and board-adopted by-laws and has endorsed private ordering through by-laws. There are a few alternative ways to address the divergent treatment of by-laws and the potential misuses of them by directors. Fisch calls for rigorous judicial scrutiny of board-adopted by-laws.[92] However, much controversy flows from the interpretations of the relevant sections of the DGCL. Common law decisions have increased ambiguity about shareholder-adopted by-laws. The Delaware courts immediately embraced a near-absolute understanding of director primacy as a matter of common law. Without any clarification of the DGCL, it seems that such narrow interpretations of shareholder by-law powers by the courts will remain. The suggested remedy would level the playing field because the courts failed to accommodate shareholders' role in corporate governance in the absence of definitive statutory language. Therefore, Delaware law could be modified to reconcile the tension between 109(b) and 141(a), and to address the potential conflict between shareholder-adopted and director-adopted by-laws. The delicate task is to ensure enough room for shareholders' by-law authority while preserving sufficient decision-making powers for the board of directors.

First, the tension between 109(b) and 141(a) of the DGCL has led courts to make a narrow interpretation of shareholder power, having director primacy accepted as a matter of common law. Any change in the wording of these sections would reduce the tension and encourage the courts to revise their positions. It is recommended that the artificial distinction between procedural and substantive by-laws be abolished. The proposed changes would also relieve directors by eliminating the possibility of a breach of their fiduciary duties by complying with shareholder by-laws. Section

[91] Walther (n 89) 412.
[92] Jill Fisch, 'Governance by Contract: the Implications for Corporate Bylaws' (2018) 106 *California Law Review* 39 (forthcoming).

109(b) could be amended to clearly indicate that by-laws could be related to procedural or substantive matters.[93] The proposed section 109(b) would be as follows:

> 'The by-laws may contain any provision, ***procedural or substantive***, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.'

In this way, there would be no need for the definition of the terms 'procedural' and 'substantive' by the courts and this insertion would prevent courts from interpreting the scope of permissible by-laws narrowly.

Second, in order to distinguish controlling by-laws from permissible by-laws and to preserve the managerial authority of the board, it would be useful to add the following sentence to the end of Section 109(b) which would empower shareholders and clearly specify the scope of permissible by-laws: 'the bylaws may not be used to mandate the decision itself'. Such a criterion would draw a boundary between what shareholders cannot do and the legal space for shareholders who are willing to play an active role. This modification would at least provide room for the emergence of an investor paradigm in the US and bring moderation to the power imbalance between shareholders and directors by requiring the board to provide a normative explanation for their actions.

Third, it would also be useful to amend section 141(a) to provide that the limitations might come through by-laws as well.[94] In the current version, it states that, '… except as may be otherwise provided in this chapter, or in its certificate of incorporation …'. The amended version would be as follows: '… except as may be otherwise provided in this chapter, in its certificate of incorporation, or *in its by-laws*'. This amendment would supplement the changes to section 109(b) and would encourage courts to reconsider their positions. This constitutes an important development which would increase shareholder influence and benefit listed companies as discussed in Chapters 3 and 4. As a result, Delaware law would become more

[93] See, Smith (n 87) 184.
[94] See Smith (n) 181.

receptive to shareholder by-laws which is a prerequisite condition for the emerging role of shareholders.

Fourth, another problem discussed in Chapter 5 is whether directors may amend or repeal shareholder-adopted by-laws. The debate again hinges on the recursive loop between sections 109 and 141. Clarification is needed, because when the board can easily undo shareholder-adopted by-laws, by-laws lose their value and have little function in corporate governance. This does not only enhance the role of shareholders, but also improves the predictability of judicial decision-making. Delaware law is silent about whether directors can amend or repeal a shareholder-adopted by-law. In the literature, there are two opposing views. Hamermesh argues that the board does have the power to undo a shareholder's by-law which seems to be limiting the board's authority.[95] However, Coffee argues the opposite.[96] The company laws of other states contain clearer regulation of shareholder-adopted by-laws. For instance, Section 211 of the California Corporate Code, which follows the Model Business Corporation Act (MBCA),[97] states that 'the articles or by-laws may restrict or eliminate the power of the board to adopt, amend or repeal any or all by-laws'.[98] Such certainty does not exist in Delaware. Given the frequent use of by-laws by shareholders, it is becoming increasingly important for the Delaware legislature to address this problem. There are a number of alternative ways to address the aforementioned uncertainty. The first option is to do nothing and to wait for the courts to decide on this matter. From the strong commitment of courts to traditional director primacy, it seems likely that the courts could decide the board has the power to amend and repeal shareholder-adopted by-laws. As discussed above, in an era of increased shareholder activism, this option would undermine shareholder activism and further insulate the board and management from shareholders. Another alternative is that directors could amend a shareholder-adopted by-law unless otherwise provided by the

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[95] Lawrence Hamermesh, 'Director Nominations' (2014) 39 *Delaware Journal of Corporate Law* 117, section IV.
[96] John Coffee, 'The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?' (1997) 51 *University of Miami Law Review* 605, 664.
[97] The Model Business Corporation Act is prepared by the Corporate Laws Committee of the American Bar Association to constitute the basis of states' company law. MBCA is the most important alternative to the Delaware General Corporation Law. See Stephen Bainbridge *Corporate Law* (3rd edition, Foundation Press 2015) 10.
[98] California Corporation Code (Title 1 enacted by Stats. 1947, Ch. 1038).

by-law. This is similar to the MBCA's approach. This option, however, could create a trap for shareholders who neglect to add no-amendment clauses into their by-laws. The final alternative is that directors cannot amend a shareholder-adopted by-law unless otherwise stated in the by-law. This option would reduce the ways in which directors could undermine shareholder power. It would remove the possibility that directors could reverse changes in the market such as proxy access or the right to call meetings as discussed in Chapter 5. This option is also close to what is articulated in section 216. Section 216 stipulates that a 'by-law adopted by the stockholders, prescribing the vote required for the election of directors, may not be amended or repealed by the board of directors'. The only difference is that the proposed solution provides that shareholders could opt out from a no-amendment rule. The developments of shareholders' rights would therefore be ensured and shielded from the board's amendment. To this end, a sentence could be added to the end of Section 109(a) as follows: 'the board cannot amend a shareholder by-law unless otherwise stated in the by-law'.

In conclusion, under the current US corporate governance shareholders cannot adopt by-laws on an equal footing with the board, even though such restrictions do not exist under section 109. This asymmetry undermines the value of shareholder activism because by-laws are the only means that shareholder could initiate and bring changes in management. In order to use by-laws optimally, shareholders should be able to effectively set governance rules through by-laws. One solution is to wait for the courts to develop a fair allocation of power. However, it seems unlikely this would ever occur given the strong commitment of the courts to director primacy. This thesis proposes statutory amendments to create a level playing field. These changes would ensure that shareholders will have sufficient shareholder by-law power as well as guarding against any changes by the board. In short, the proposed amendments adapt the law to make it conform to contemporary shareholder activism.

6.4.1.2 Private Ordering under Federal Law

By-laws are usually submitted through the Securities Exchange Act Rule 14a-8.[99] Chapter 5 demonstrated the role of Rule 14a-8 in shareholder activism and the substantive restrictions imposed on shareholder participation by that rule. The rule breathes life into private ordering. With the increasing use and success of shareholder proposals in US corporate governance, some major institutions, and scholars too, call for reforms to tighten Rule 14a-8 which would effectively eliminate the use of proposals for most shareholders. However, while the general framework of Rule 14a-8 is sensible, it fails to facilitate private orderings and to reflect the evolving features of shareholder activism in the era of investor capitalism. The debate therefore becomes whether and how the rule should be structured in the new investor paradigm.

These calls for reform are, in a sense, a response to the dramatic increase in the use of shareholder proposals on a wide range of matters over the last two decades.[100] It is argued that the rule is in a need of modernisation.[101] The proposed changes are aimed at imposing additional restrictions on the submission of shareholder proposals through Rule 14a-8 and reducing the role of shareholders in US corporate governance. The critics of Rule 14a-8 are of the view that the rule is overly used by a limited number of shareholders who submit similar proposals to a large number of companies, but only own a small amount of shares of the companies. These shareholders are regarded as having no material interest in the creation of value and of being self-interested.[102] Shareholders are able to submit a vast number of proposals because of the low ownership threshold set out in Rule 14a-8. It is argued that the

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[99] 17 CFR 240.14a-8.

[100] Stephen Bainbridge, 'Revitalising SEC Rule 14a-8's Ordinary Business Exclusion: Preventing Shareholder Micromanagement by Proposal' (2016) 85 *Fordham Law Review* 705; US Chamber of Commerce et al., 'Petition for Rulemaking regarding Resubmission of Shareholder Proposals Failing to Elicit Meaningful Shareholder Support' (SEC, 27 March 2014) <https://www.sec.gov/rules/petitions/2014/petn4-675.pdf> accessed 06 June 2017.

[101] Business Roundtable, 'Modernising the Shareholder Proposal Process' (31 October 2016) <http://businessroundtable.org/resources/responsible-shareholder-engagement-long-term-value-creation> accessed 06 June 2017; James Copeland, 'SEC Rule 14a-8 - Statement to the House Committee on Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises' (Financial Services Committee, 21 September 2016) <https://financialservices.house.gov/uploadedfiles/hhrg-114-ba16-wstate-jcopland-20160921-rev.pdf> accessed 05 June 2017.

[102] Business Roundtable (n 101).

$2000 ownership threshold does not reflect the reality of share prices in the current market. An illustration of this is that three shares of Google is enough to satisfy the requirement.[103] A minority of shareholders, therefore, bring significant costs to the company at the expense of other shareholders.

From the traditional director primacy perspective, Bainbridge argues that 'many proposals address issues traditionally regarded as board or management prerogatives, as a substantial number effectively seek to manage or even micromanage corporate decisions'.[104] Even though proposals are non-binding in nature, they become a powerful tool in influencing the board and management. Moreover, shareholder proposals are used to enhance shareholder participatory rights. Shareholders are debatably characterised as having an 'essentially passive and reactive role' under state law.[105] Bainbridge therefore claims that Rule 14a-8 undermines the corporate governance structure created by state law because it allows shareholders to play an active role.[106] However, ordinary business exclusion has, it is argued, failed to protect the board from shareholder proposals.[107] Furthermore, the SEC and federal courts are criticised for reducing the number of excludable proposals by precluding the exclusion of proposals that involve matters 'which have significant policy, economic or other implications inherent in them'.[108] Hence, it is in essence argued that the rule fails to preserve the allocation of powers between shareholders and directors under state law. Bainbridge suggests tightening the number of ordinary business exclusions to eliminate social shareholder proposals.[109] He further proposes that the courts consider whether a shareholder proposal has material economic importance for the value of shares rather than searching for whether a shareholder proposal implies a significant policy issue that transcends the ordinary business of the company. Similarly, Business Roundtable has sought reconsideration of the ordinary business exclusion to limit the number of shareholder proposals, increase the $2000 ownership threshold and extend

[103] Business Roundtable (n 101).
[104] Bainbridge (n 100), 710.
[105] Bainbridge (n 100) 714.
[106] Bainbridge (n 100) 735.
[107] Bainbridge (n 100), 711.
[108] *Austin v. Consolidated Edison Co. of New York, Inc.*, 788 F. Supp. 192, 194 (S.D.N.Y. 1992).
[109] Bainbridge (n 100) 735.

the holding requirement. Calls for reforms aim to reduce the role of shareholders in corporate governance.

The descriptions offered by critics fail to accurately reflect the state of the shareholder proposal process. The most significant trigger of reform calls is the increasing use and success of proposals.[110] Academics and institutions calling for restrictions on the use of shareholder proposals aim to avoid such influence by limiting the shareholders' proxy access. The critics of Rule 14a-8 often overlook the fact that a wide range of institutional shareholders rather than a minority of shareholders are interested in corporate governance, practices and strategies. At present, not just social funds but also mainstream investors as well as activist funds are the proponents of shareholder proposals. Therefore, the claim that the process of shareholder proposals is abused by a minority of shareholders lacks credence.

Turning to the criticism that shareholder proposals are inconsistent with US corporate governance, this objection overlooks the fact that Rule 14a-8 does not grant an additional right to shareholders, but only effectuates the use of private ordering. As discussed in Chapter 5, US company law adopts a flexible approach which enables directors and shareholders to shape corporate governance rules. Shareholder access to proxy statements is a prerequisite for flexible company law because in listed companies, shareholders do not generally attend meetings in person and exercise their rights through proxy voting. It is therefore nothing more than making meaningful the right of shareholders to initiate private ordering through resolutions and by-law amendments. Any restriction on Rule 14a-8 limits shareholders' authority to adopt by-laws.

Critics of Rule 14a-8 undervalue the contributions of shareholders to corporate governance through shareholder proposals. Proposals provide companies with the means to obtain the collective views of shareholders, i.e. their feedback on corporate performance. The process of shareholder proposals forces the board to provide normative account-giving for their actions. Consequently, shareholder proposals drive increased communication between the board and shareholders. Directors and

[110] See Chapter 5.

managers can better understand the shareholders' approaches and behaviour. It not only provides a snapshot of the views of shareholders, but also enhances the decision-making of the board as discussed above. As a result of activism, many companies have made a number of changes to their corporate governance structures. The changes were not limited to governance issues, but also covered social issues such as gender pay equity, board diversity, equal employment opportunities, animal welfare and sustainability efforts.[111] Even though socially responsible proposals do not often receive sufficient support from shareholders, they can signal to companies potential weaknesses in corporate governance and strategies. For instance, a shareholder proposal calling for the appointment of a climate expert to the board of Exxon-Mobil failed to receive a majority, but in the end, Exxon itself appointed a climate expert director to the board.[112] In short, proposals are critical components of direct communication and engagement between shareholders and the board. So tightening Rule 14a-8 would deprive the board and managers from the valuable insights of shareholders.

Some aspects of Rule 14a-8 could, nonetheless, do with updating. The rule entered into force at a point in time before significant shareholder activism took place in US corporate governance. At that time, the Wall Street Rule and the subsequent share price reactions were accepted as the primary mechanism between the board and shareholders. During that era, even the submission of a shareholder proposal could be regarded as a kind of abuse.[113] The way in which substantive exclusion grounds are structured also demonstrates that shareholder proposals were seen as a threat to corporate governance rather than an integral part of corporate governance. As discussed in Chapters 3 and 4, shareholder activism became one of the important aspects of US corporate governance and can no longer be regarded as a form of abuse. The history of the enforcement of Rule 14a-8 by the SEC and courts has been

[111] Robert Brown, 'Corporate Governance, Shareholder Proposals, and Engagement between Managers and Owners' (2017) 94 *Denver Law Review* 1, 16.
[112] Ed Crooks, 'ExxonMobil Appoints Climate Scientist to Board' *Financial Times* (26 January 2017) < https://www.ft.com/content/d87ce444-e388-11e6-8405-9e5580d6e5fb> accessed 10 June 2017.
[113] Susan Lieber, 'A Proposal to Rescind the Shareholder Proposal Rule' (1984) 18(3) *Georgia Law Review* 425, 446 ('The Wall Street Rule 123 is the only practical rule by which sensible investors are governed. Small investors who do not like management sell their shares').

tumultuous, and the Rule itself has undergone a number of changes as discussed in Chapter 5.[114] However, it does not reflect the changes in shareholder activism, and the increased engagement between shareholders and the board/managers. The proposed approach is to make proxy rules consistent with state-based shareholder rights. Under the current regulation, legitimate shareholder proposals sanctioned by state law can be excluded from proxy statements of the company. A typical example was the directors' election proposals discussed in Chapter 5. Clearly, the substantive exclusion grounds need to be reworked and narrowed substantially. Of course, this does not mean unlimited access to a company's proxy materials on any matter. In principle, such limitations should not be related to substantive matters. In line with the general approach described above, the proposed amendments would enhance shareholders' rights while maintaining the centralised decision-making authority of the board.

There are overall thirteen exclusion grounds under Rule 14a-8. Three of them are merit-based exclusion grounds discussed in Chapter 5. The decision whether a proposal is a proper subject under state law, or an ordinary business matter, or 'substantially related' to a company's business – three exclusionary grounds – actually tests the merits of shareholder proposals. The remaining grounds for exclusion primarily seek to eliminate vexatious, illegal and deceptive proposals. They are therefore necessary to filter out unnecessary proposals.

Merit-based exclusion grounds are the most controversial. Among them, the ordinary business matter is the most litigated and used by companies. Revision of Rule 14a-8 should focus on the removal of subjective and vague terms and interpretations by the SEC that create controversy and tension in their application. Rule 14a-8(i)(1) 'proper subject under state law exclusion' stands on different ground than the other two merit-based exclusion grounds. It is a filter that aims to eliminate proposals which would not be valid under state law, so it does not impose any additional restrictions on shareholders. However, this could cause difficulties for the SEC when examining whether a proposal is a proper subject under state law.[115] When they are not sure about

[114] Alan Palmiter, 'The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation' (1994) 45 *Alabama Law Review* 879, 881.
[115] Palmiter (n 114) 905.

the permissibility of a proposal, the staff of the SEC should allow it, leave the matter to shareholders and ultimately to the Delaware courts. Congruously, Strine, who was Vice Chancellor and is now Chief Justice of the Delaware Supreme Court stated that:

> 'I think those of us from Delaware would say one of the things the Commission could do to facilitate this is to make clear that if it's uncertain under state law and it's a by-law proposal, then it shouldn't be excluded and they should be able to put it on absent some showing, and then leave it to us, hold us accountable, and if we make the wrong decisions, you can bet we are going to hear about it from the institutional investor community and from the management community'.[116]

The upshot is that the proper subject under state law exclusion grounds should not be interpreted broadly.

The relevance exclusion ground was originally introduced to prevent proposals 'promoting general economic, political, racial, religious or social causes'.[117] The SEC abandoned this rule and adopted an objective relevance test (5% of the company's assets, earnings or gross sales) and a subjective test (if a shareholder proposal is not otherwise related to the company's business). There are basically two possibilities: first, a proposal's sole focus might be economically-orientated, in which case it is relatively straightforward to determine whether it satisfies the 5% economic test. Second, even though a proposal does not satisfy the economic test, it could be 'otherwise significantly related to the company's business'. As regards the first possibility, if a proposal is economically insignificant and has no social aspect, its outcome will likely be immaterial. This type of proposals is likely to be within the managerial prerogatives of the board under section 141 of the DGCL. Therefore, the 'proper subject under state law' and the 'ordinary business matter' exclusion grounds ensure the omission of the proposal. As regards the second possibility, if a proposal is related to a company's business and social issues, the economic test rarely matters. It is difficult for the SEC to assess the merits of social and political proposals. The determination of the ethical and social significance of the proposal could be left to shareholders. As discussed in Chapters 3 and 4, these issues might also be value-

[116] Leo Strine, 'the Roundtable on the Federal Proxy Rules and State Corporation Law' (SEC, 7 May 2007) < https://www.sec.gov/spotlight/proxyprocess/proxy-transcript050707.pdf > accessed 10 June 2017.
[117] SEC, Solicitation of Proxies, 17 Fed. Reg. 11,425 11431 (18 December 1952).

enhancing for some companies and could be related to the sustainability of companies and the economy in general. Therefore, instead of leaving the decision to the SEC or federal judges, it seems appropriate to leave the ultimate outcome to shareholders. The board and management could make a case against the proposal and could persuade shareholders. If the proposals were prepared in a way which undermined the board's authority, they could be excluded under the 'proper subject under state law' ground. This analysis suggests a repeal of this exclusion ground is needed.

The ordinary business exclusion ground is the most used and litigated exclusion ground by companies. This exclusion ground aims to filter out proposals involving 'routine, day-to-day matter[s] relating to the conduct of the ordinary business operations of the issuer'.[118] However, it imposes a difficult task on the SEC: to decide whether the proposal is within the scope of the ordinary business exclusion ground and whether it raises significant policy issues which are 'so significant that it would be appropriate for a shareholder vote'.[119] The SEC faces difficulties in analysing the merits of proposals and developing a consistent and coherent criteria in applying the exclusion ground. There have been shifts away from proposals being treated as excludable to proposals treated as includable and vice versa. Moreover, the SEC has usually failed to react in a timely manner. It takes governance failures or newsworthy public debate for the SEC to change its position; instead, it should establish a clear test to determine which kind of proposals are includable or excludable. For instance, until the Enron failure, companies were able to omit shareholder proposals regarding the independence of auditors. After the Enron failure, the SEC reversed its position.[120] Another example is Tyson Foods in which the SEC reversed its position. Shareholders may have to wait several years for public pressure or a widespread governance crisis to change the SEC's position and to allow such proposals. Even the same dispute can result in three different opinions at the same time. The current regulation fails to establish a consistent and coherent standard that responds in a timely manner to major

[118] SEC, Proposed Amendments to Rule 14a-8 under the Securities Exchange Act of 1934 relating to proposals by Security Holders, 41 Fed. Reg. 29,982, 29,988 (7 July 1976).
[119] SEC, Amendments to Rules on Shareholder Proposals, Exchange Act Release No: 34-40018 63 Fed. Reg. 29,106, 29108 (28 May 1998)
[120] The Walt Disney Co., SEC No-Action Letter, (SEC, 18 December 2001) < https://www.sec.gov/Archives/edgar/vprr/0201/02011019.pdf> accessed 12 June 2017.

changes in the market or to public debate. Instead of maintaining the exclusion, this thesis suggests the elimination of this exclusion ground.[121] The elimination of this exclusion ground would have no substantive impact on the allocation of power between shareholders and directors and would not unnecessarily intrude on the board's authority because the rule does nothing more than express the implications of the proper subject under state law exclusion ground differently. The SEC stated that the underlying purpose of the ordinary business exclusion ground was 'consistent with the policy of most state corporate laws: to confine the resolution of ordinary business problems to management and the board of directors, since it is impracticable for shareholders to decide how to solve such problems at an annual shareholders meeting'.[122] Since the proper subject exclusion ground still exists, the purported purpose of the ordinary business exclusion ground could be achieved under the proper subject exclusion ground because section 141(a) of the DGCL clearly provides managerial authority to the board.[123] This thesis recommends that this process be left to shareholders to decide, and in the case of a dispute between the board and shareholders, Delaware law could decide whether such proposal is a proper subject and within the scope of permissible by-laws. The proposed change would allow shareholder activism to play a corrective function before another large-scale accounting scandal happens or a public controversy mounts that affects the business of companies.

The removal of the aforementioned merit-based exclusion grounds may lead scholars to argue that the corporate governance created by state law is substantially eliminated as a result of the amendments. However, the case is the opposite. These merit-based restrictions on shareholder proposals appear to be inconsistent with state law. Section 109(b) of the DGCL grants substantial authority to initiate governance changes and does not specify a limit on shareholder power other than being consistent with law or with the certificate of incorporation. The proposal will be left to the shareholder voting process, and if there is any doubt about the legality of the proposal,

[121] The removal of merit-based exclusion grounds has been advocated by several scholars. See Palmiter (n 114) 885.
[122] SEC (n 119) 29108.
[123] Robert Clark *Corporate Law* (Aspen 1986), 373.

the dispute will be resolved by the Delaware courts rather than the SEC. Since the proposals would initially be voted upon by shareholders, the directors and shareholders could compromise rather than take every instance to court. In other words, state law would resolve the legality of proposals. With these recommended changes, shareholder proposals would no longer be considered as a threat to corporate governance; rather, they would be an internal aspect of corporate governance. Implementing the proposed changes would help shareholder activism to be partly accommodated within US corporate governance. At the same time, the board's authority would be preserved because in the event of overt intrusion into the board's prerogatives, Rule 14a-8(i)(1) would prevent the inclusion of such proposals.

The proposed approach not only aims to make proxy regulation consistent with state-based shareholder rights but also seeks to preserve the board's authority. The rest of the thirteen exclusion grounds could filter out vexatious, frivolous and unreasonable proposals, which cause distractions and waste the time of the board and management. However, as critics have rightly argued,[124] the $2000 threshold does not reflect the realities of company shares. The disadvantage of employing a fixed dollar amount is that the specified amount of money becomes irrelevant over time because of inflation. The $2000 share ownership could be an infinitesimal percentage of the total share value of some companies. Commenting on this issue, Gallagher, the former SEC commissioner, stated that '$2,000 is absurdly low'.[125] For instance, Apple's market capitalisation was around $776.6 billion as of April 2017.[126] A $2000 share ownership of Apple amounts to 0.00000026% of Apple's total shares or 14 shares in the company. In other words, a shareholder who owns 14 shares of Apple could submit a proposal and therefore shareholders who do not have any reasonable material ownership of the company could submit proposals. It is quite possible that the proposals submitted by these shareholders would focus on issues that are neither

[124] The House Committee on Financial Services, The Proposed Financial Choice Act of 2017, HR 10, 115th Cong., 1st Sess. (26 April 2017).
[125] Daniel Gallagher, 'Remarks at the 26th Annual Corporate Law Institute: Federal Pre-emption of State Corporate Governance' (SEC, 27 March 2014) < https://www.sec.gov/news/speech/2014-spch032714dmg.html> accessed 16 June 2017.
[126] The House Committee on Financial Services, 'A Republican Proposal to Reform The Financial Regulatory System' (24 April 2017) 133 < https://financialservices.house.gov/uploadedfiles/2017-04-24_financial_choice_act_of_2017_comprehensive_summary_final.pdf >

financially nor socially material to the company. As discussed in Chapter 3, shareholder activism can sometimes be excessive and distracting for the board and management. These proposals come at a significant cost to the company because they waste corporate resources and consume significant amounts of management time through negotiations with proponents, seeking no-action letters, or preparing counter-proposals. Such proposals may cause mainstream institutional shareholders to lose focus on serious matters and delay action on economic and social decisions of real importance to the investee company. This analysis suggests the removal of the $2000 ownership threshold and maintaining the 1% ownership requirement under Rule 14a-8. In doing so, the value of shares required for the submission of shareholder proposals would vary from company to company based on size and share price.

In conclusion, an update to Rule 14a-8 is needed to reflect market developments. This thesis proposes an approach that seeks to make proxy rules consistent with state law. It aims to allow shareholders to exercise their state-based rights more efficiently and suggests where there is a doubt on the legality of shareholder proposal, it should be left to shareholders, and ultimately state courts. It suggests the elimination of the relevance and ordinary business exclusion grounds. It also recommends the use of a 1% ownership threshold alone rather than the $2000 threshold. Implementing such changes would deliver much-needed improvements and help shareholder activism to be better accommodated within US corporate governance while preserving the centrality of the board's authority.

6.4.2 The Case for Making Director Elections More Meaningful

Chapter 5 demonstrated that shareholders have long been impeded exercising meaningful voice in the context of director elections. While shareholders still do not have default proxy access in the case of director elections, they could adopt proxy access through private orderings. The availability of such private ordering is generally found sufficient because it can produce proxy access when it is desirable.[127] However, this thesis argues that in order to accommodate shareholder activism within US corporate governance, there is a case to be made for changing default regimes to create

[127] Joseph Grundfest, 'The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law' (2010) 65(2) *The Business Lawyer* 361.

a level playing field. This analysis extends beyond default no-access regimes to plurality voting rules and universal proxy voting cards.

6.4.2.1 Adopting the Default Proxy Access Model

Since the current legal framework provides a no-access regime to shareholders with the freedom to adopt a proxy access model, the default regime is considered sufficient. It is argued that the legal framework provides shareholders with the flexibility to tailor a system of proxy access that depends on the needs of the company.[128] It seems reasonable that one-size-does-not-fit-all, but it also does not justify why the default regime should start from a no-access position. Similarly, a default access regime could be structured with an option to opt out of the access regime. Bebchuk and Hirsch argue that the ease of reversing default rules should be also taken into account when deciding the default regime.[129] They argue that the opting out of a no-access regime would be far more difficult than opting out of an access regime.[130] Opting out of a no-access default is difficult when shareholders favour it but the board disfavours it because the board would subject the proposal to a vote and have the resources to draft and articulate the proposal expertly, as well as place the proposal in the company's proxy material.[131] As a result, there is an asymmetry between the opt-outs favoured and disfavoured by the board. Moreover, the design of proxy access is complicated because a proposal should contain information regarding the minimum ownership threshold and duration, the details of the shareholders nominating the director, the number or proportion of directors who can be nominated by directors, and the eligibility criteria for the directorial candidates. Therefore, there are many ways of designing the proxy access proposals. Directors could adopt a proxy access proposal which makes the use of the proxy access system very difficult for shareholders in practice. As discussed in Chapter 5, these by-law proposals are non-binding in nature

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[128] Business Roundtable, 'Facilitating Shareholder Director Nominations' (SEC, 14 September 2009) < https://www.sec.gov/comments/s7-10-09/s71009-267.pdf> accessed 10 June 2017; Wachtell, Lipton, Rosen & Katz et al., 'Letter to SEC regarding Facilitating Shareholder Director Nominations' (SEC, 17 August 2009) < https://www.sec.gov/comments/s7-10-09/s71009-212.pdf> accessed 10 June 2017.

[129] Lucian Bebchuk and Scott Hirsch, 'Private Ordering and the Proxy Access Debate' (2010) 65 *The Business Lawyer* 329, 338.

[130] See also, Lucian Bebchuk and Assaf Hamdani, 'Optimal Defaults for Corporate Law Evolution' (2002) 96 *Northwestern University Law Review* 489, 489.

[131] Bebchuk and Hirsch (n 129) 339.

and could be amended later on by the board itself under the current legal framework. The board may adopt a more restrictive proposal with higher thresholds and requirements than the proposal favoured by shareholders. Until recently, many shareholder proposals which had received the majority support had been disregarded by the board.[132] Retaining no-access and adopting a company-by-company approach might therefore not provide the desired outcome in terms of proxy access arrangements. Finally, the shareholder access proposal could easily exceed the 500-word limitation imposed by Rule 14a-8 given that the invalidated Rule 14a-11 was around 2000 words.[133]

A proxy access opt-out could provide a solution to boards captured by management. Candidates nominated by shareholders are an effective solution to captive boards and seek to replace underqualified and ineffective directors. These directors help the board to bridge the information asymmetry existing between the board and management and enhance the monitoring capacity of the board. Directors nominated by shareholders do not seek to paralyse managerial activity, rather they aim to deliver new information and perspectives to the board members to enhance the monitoring capacity of the board. Better monitoring does not necessarily come at expense of the efficient board activities. Therefore, in conformance with the director primacy theory model, a proxy access opt-out regime is not automatically disruptive to the functioning of the board. These directors could reduce the cohesiveness and trust-based relationships in the boardroom. However, as discussed in Chapter 2, a friendlier and more cohesive boardroom significantly reduces the monitoring capacity of the board and causes significant corporate governance failures because these boards usually avoid taking hard disciplinary actions against management. The result is that a proxy access opt-out system creates a meaningful nomination process which would substantially increase the disciplinary power of shareholder voting and help corporate governance to function better.

Proxy access also appears to be the one of the pillars of director primacy under state law because the ability of shareholders to replace and elect directors is often used

[132] Bebchuk and Hirsch (n 129) 343-5.
[133] Bebchuk and Hirsch (n 129) 341.

by the courts to justify director primacy in US corporate governance. It broadens the pool of candidates. Otherwise, where shareholders do not have an effective right to nominate directors, they are left with the list of candidates nominated by the board and management and have no option but to elect these directors. As discussed in Chapter 5, the right to nominate directors exists in state law. Proxy access would allow shareholders to meaningfully exercise their state-based right to nominate directors. The current legal framework makes it difficult for shareholders to replace directors and provides the incumbent board and management with significant advantages over shareholders seeking to nominate new directors.

The analysis above suggests that there is a strong case for implementing an opt-out access regime in place of the current opt in no-access regime. Unlike the invalidated Rule 14a-11, this thesis argues that companies should be able to opt out of the access regime or to modify, strengthen or restrict shareholders' access rights. The company-specific and industry-specific features, and the company's shareholder base would determine the effectiveness and the optimal level of shareholder activism. The optimal eligibility thresholds may therefore vary from company to company. For instance, a company with a long-term and dominant CEO might need to employ strong nomination rights to ensure the board's independence, or a company operating in an industry that requires prolonged investment may wish to enhance the nomination rights of shareholders that are committed to the long-term.[134] Companies may need to limit excessive shareholder activism. A director election procedure could be valuable for some companies but could be value-reducing for others. Moreover, the governance requirements of companies may change over time and need to be modified according to company-specific factors. In addition, factors surrounding companies such as the market, the economy or political developments could change over time necessitating a new relationship between the board and shareholders.[135] A flexible rule allows companies to employ variable criteria such as the ownership threshold or hold periods according to specific circumstances. Therefore, rather than mandatory and uniform rules that prevent the company from changing them, default rules could provide both

[134] Jill Fisch, 'The Destructive Ambiguity of Federal Proxy Access' (2012) 61 *Emory Law Journal* 435, 486.
[135] Fisch (n 134) 486.

proxy access and flexibility that companies could arrange according to their firm-specific characteristics.

6.4.2.2 Adopting the Majority Voting Rule

The analysis has so far focussed on proxy access, but as noted above, the discussion extends beyond proxy access to the selection of other default regimes and universal proxy cards. As discussed above, the ability of shareholders to replace directors enhances their accountability and the decision-making of the board. It would therefore be better to reconsider other existing arrangements such as the plurality voting rule and proxy card regulations so that shareholders can meaningfully exercise their rights.

As discussed in Chapter 5, the plurality voting rule in the US makes director elections almost meaningless and in uncontested elections directors could be elected even if the majority of shareholders did not support them. In this regard, shareholders are left with only the Wall Street Rule rather than voice because their dissatisfaction has no consequences for the board and management. Indeed, given the practical difficulties in nominating directors independently before the 2009 changes, elections were really only a hollow ceremony for institutional shareholders other than activist funds because a limited number of shareholders were able to nominate candidates. As rightly argued by Hirschman, shareholder activism will likely take place where shareholders believe that the activism could be effective.[136] The majority voting rule could partially address this problem and make director elections more meaningful.[137] The majority voting rule allows shareholders to vote effectively in favour of or against a directorial candidate. If the candidate does not receive more 'for' votes than 'against votes', she or he will fail to be elected. A director is therefore required to provide normative account-giving for the board's actions and decisions because otherwise she or he might not secure the directorship for another term. Under the plurality voting rule, with shareholders having restricted nomination powers, a director would be aware of the fact that she or he would be elected regardless of the outcome of the election, so she or he would have less incentive to explain her or his decisions and

[136] Hirschman (n 6) 1970) 37.
[137] The majority vote is definitely not unknown in the US literature and has been discussed in the course of reforming company law. See Julian Velasco, 'Taking Shareholder Rights Seriously' (2007) 41 *University of California, Davis* 605.

actions and to establish direct communication with shareholders. What is more, as discussed in Chapters 3 and 4, mainstream investors usually only carry out defensive activism. Therefore, they are less likely to nominate directors. Mainstream investors should be able to show their dissatisfaction by simply casting votes. The majority voting rule better fits with contemporary shareholder activism and the business model of mainstream investors. It basically forces the board and management to nominate a new director who fits the criteria of shareholders. Therefore, there is a compelling rationale to change the plurality voting default for a majority voting default.

It is possible to argue that since shareholders are able to change default rules, there is no need to change them. Moreover, shareholders are successfully implementing changes to majority voting. While this may appear to support the former argument, it may also suggest that default rules are no longer found to be efficient or desirable by shareholders and the time may have come to reform them. As discussed in Chapter 5, shareholders have long had the power to adopt, amend and repeal by-laws without the approval of directors. Yet, it is not always easy for shareholders to amend by-laws for legal and practical reasons. Due to the complicated proxy regulations, Delaware law had to make amendments to indicate what kinds of by-law are permissible. Otherwise, the proposals could be prevented by the board under Rule 14a-8. Therefore, the enabling nature of the provisions does not support the argument that any changes in the legal rules are unnecessary. Rather, it suggests there is a need for legal reform and that a majority voting rule would be a better fit in the era of investor capitalism.

6.4.2.3 Adopting the Universal Proxy Cards

These proposed changes would make director elections more meaningful and encourage shareholders to nominate directors. However, the proxy rules cause an intangible difficulty in the election of directors. Under current regulations, shareholders in principle receive two separate proxy cards for director elections: management’s and dissident’s proxy cards. Each card contains a specific slate of candidates. At the meeting, proxy holders appointed by shareholders complete a ballot on behalf of shareholders.[138] Although shareholders could theoretically appoint their agents to vote on their behalf, in practice all proxies are distributed by parties who nominate the candidates for the election.[139] Rule 14a-4 creates a peculiar problem. Under Rule 14a-4, nominees that only consented to be included on proxy cards and to serve as directors can be named in the party's proxy statement.[140] Parties do not include other parties' candidates on their proxy card or allow their candidates to be named on the other proxy card. A proxy card, therefore, contains only the party's nominees. Shareholders voting by proxy cannot make a selection based on their preferences. However, shareholders who are present at the meeting are able to select among all the directorial candidates nominated by any party and vote for any of them.[141] A further reform that would enhance the election of directors would be universal proxy cards as these would provide shareholders with the opportunity to vote for any candidate who was properly nominated. The proxy cards would become universal ballots. On 26 October 2016, the SEC proposed amendments to proxy rules which would require companies to include the names of all directorial candidates nominated by the management and shareholders on a single proxy card, namely a universal proxy card.[142] Implementing this amendment would make shareholders voting by proxy to a very large extent closer to shareholders who are present at the meeting and voting in person.

This call for reform has been opposed on the basis that it would increase the frequency of contested elections and empower shareholders with special interests.[143] The objections are not well-founded as discussed in Chapter 3. On the contrary, it makes the right to nominate directors more meaningful in the shadow of the law. Furthermore, shareholders are allowed to vote for a combination of candidates when

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[138] Section 211(e) of the DGCL.

[139] Scott Hirsch, 'Universal Proxies' (2016), 16 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2805136 accessed 27 October 2016.

[140] 17 C.F.R. § 240.14a-4 ('No proxy shall confer authority…to vote for the election of any person to any office for which a bona fide nominee is not named in the proxy statement')

[141] SEC, 'Universal Proxy' Release No. 34-79164; IC-32339 (SEC, 26 October 2016).

[142] SEC, 'Press Release: SEC Proposes Amendments to Require Use of Universal Proxy Cards' (26 October 2016) https://www.sec.gov/news/pressrelease/2016-225.html accessed 26 October 2016.

[143] US Chamber of Commerce (UCC), 'U.S. Chamber Statement on SEC Proposed Rule Regarding Universal Proxy Ballots' (26 October 2016) https://www.uschamber.com/press-release/us-chamber-statement-sec-proposed-rule-regarding-universal-proxy-ballots accessed 27 October 2016.

they attend the meeting in person in the US.[144] Why should they be banned from doing so just because they vote by proxy?

Universal proxy cards would lead to dramatic changes in directorial elections because they would allow shareholders to vote for their chosen combination of candidates. In the context of the current system of contested elections, i.e. unilateral proxies, shareholders have to vote for either one of the slates and cannot ‘mix and match’ from the two sides.[145] This prevents mainstream funds from objecting to a complete slate of management or supporting the activist funds when they do not approve of some of the candidates nominated by the management. Shareholders would be able to support just a part of the slates rather than all of it. The proposed reforms would significantly enhance the role of shareholder activism, and also allow the best candidates to be chosen regardless of their nominators.

Implementing the proposed amendments will provide significant advantages. Shareholders will gain an effective right to nominate directors and any disadvantage stemming from being on a separate card will be eliminated. Majority default rule will enable shareholders to force a particular director not to be elected. This will increase shareholders’ prospects of effectively using their voice. As a matter of law, these proposed amendments would be a better fit with the courts’ justification for the business judgment rule. Shareholders would be able to replace directors if they were not happy with the business strategy adopted by the board and management. Since these changes are not mandatory in nature, companies could implement a number of alternative procedures, adjusted to the level and type of shareholder activism according to the governance needs of companies. These proposed changes will make the law flexible enough to accommodate shareholder activism in US corporate governance without displacing the incumbent management. These amendments, in general, provide a fair opportunity for shareholders to nominate directors while preserving the incumbent management’s power to nominate directors.

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[144] SEC, ‘Press Release: SEC Proposes Amendments to Require Use of Universal Proxy Cards’ (26 October 2016) https://www.sec.gov/news/pressrelease/2016-225.html accessed 26 October 2016.

[145] Scott Hirsch, ‘Universal Proxies’ (2016) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2805136 accessed 27 October 2016.

6.4.3 The Case for Enhancing the Disclosure Regime of Shareholders

This thesis has shown that institutional shareholders play a key role in correcting managerial errors, enhancing decision-making of the board and addressing accountability concerns. But in some cases, shareholders in particular activist funds engage in controversial transactions to advance their own interests through risk-decoupling techniques and wolf-packs. The activist funds' controversial objectives provoked a fierce debate about the US disclosure regime.[146] The Dodd-Frank Act expressly authorised the SEC to shorten the 10-day time period (discussed below) but the SEC made no attempt to do so.[147] NASDAQ and the NYSE also asked the SEC to reconsider the disclosure regime for short-positions of shareholders.[148] Recently, the Brokaw Act[149] proposed to enhance the oversight of activist funds.[150] Tightening the disclosure regime is aimed at controlling and limiting the activities of activist funds. However, there is a possibility that such reform calls could to be too broad to the extent that they could completely eliminate shareholder activism because the business model of activist funds primarily depends on the disclosure regime. This would be value-decreasing overall for companies and the market. Regulation of institutional shareholders' governance role must therefore strike a delicate balance.

Shareholders of listed companies are subject to numerous disclosure requirements under securities law that are primarily designed to release information to the public regarding the accumulation of substantial share ownership of a company. US securities law requires that when a shareholder or a group of persons accumulate

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[146] Lucian Bebchuk and Robert Jackson, 'The Law and Economics of Blockholder Disclosure' (2012) 2 *Harvard Business Law Review* 39; Wachtell, Lipton, Rosen & Katz, Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, (SEC, 7 March 2011) < https://www.sec.gov/rules/petitions/2011/petn4-624.pdf> accessed 15 September 2016; John Coffee and Darius Palia 'The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance' (2016) 1(1) *Annals of Corporate Governance* 1.

[147] Section 929R of the Dodd-Frank Act.

[148] NASDAQ, 'Petition for Rule-Making to Require Disclosure of Short Positions in Parity Required Disclosure of Long Positions' (7 December 2015) < https://www.sec.gov/rules/petitions/2015/petn4-691.pdf> accessed 17 June 2017; NYSE, 'Petition for Rulemaking Pursuant to Sections 10 and 13(f) of the Securities Exchange Act of 1934' (SEC, 7 October 2015) < https://www.sec.gov/rules/petitions/2015/petn4-689.pdf> accessed 17 June 2017.

[149] The Brokaw Act, S. 2720, 114th Cong. (2016).

[150] Donna Borak and David Benoit, 'Democrats Take Aim at Activist Investors' *The Wall Street Journal* (17 March 2016) < https://www.wsj.com/articles/democrats-take-aim-at-activist-investors-1458251491> accessed 15 June 2017.

more than 5% of a voting class of a company's shares, they must disclose their ownership within 10 days of the acquisition.[151] The 5% and the 10-day time window provide an advantageous legal environment to activist funds, compared to other jurisdictions.[152] For instance, in the UK, a 3% ownership threshold and 2-day time window applies.[153] In this regard, while US corporate law makes corporate governance restrictive for shareholder activism, the securities regulations make it shareholder-friendly. Therefore, following the 2007-2008 financial crisis, the US disclosure regime also attracted attention from lawmakers and academics to limit hedge fund activism.

From the perspectives of mainstream investors and directors, the disclosure of share ownership and risk-decoupling techniques is also important for the existing shareholders of the target company because the accumulation of shares by activist investors often means potential changes in the business strategy of the target company. As discussed in Chapter 3, mainstream investors show in interest in issues such as short-termism, and the objectives and proposals of activist funds. It is therefore crucially important for them to have knowledge of the composition and dynamics of the shareholder base and whether activist funds have negative interests in exercising voting rights. From the perspective of activist funds, disclosure rules play a key role in the sustainability of offensive shareholder activism. Activist funds must be able to recover the costs of activism. The cost recovery of activist funds usually depends on a sizeable share ownership purchased before the disclosure of the ownership because a share price increase generally follows the disclosure of the accumulation of shares by an activist fund. While the enhanced disclosure may provide better information regarding activist funds to companies and mainstream investors, it could make it relatively difficult for activist funds to recover their expenses.

Regulatory reform calls focus on four elements of the disclosure regime: shortening the time window, broadening the scope of beneficial ownership, the definition of group and including short-positions in the disclosure requirements. Each element aims to address the business model of activist funds. The overall impact of

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[151] 17 CFR 240.13d-1.
[152] Alessio Paccess, 'Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance' (2016) 4 *Erasmus Law Review* 199, 212.
[153] D.T.R. 5.1.2., FSA Handbook.

these reform suggestions might cause activist funds to shrink and only a few companies to be targeted by activist funds because these reforms would substantially reduce the returns from activism. This might result in an overall decrease in shareholder activism and accountability problems. Therefore, we need to strike a balanced approach in regulating the disclosure regime.

The first policy question is related to the length of time window. Proponents of a shorter reporting window are of the view that the 10-day window allows activist funds to secretly accumulate a sizeable stake in the company, to report material information in an untimely manner, to trade ahead of the market and to maximise their profits at low risk and possibly at the expense of uninformed shareholders.[154] Changes in technology and the advent of computerised trading enable shareholders to accumulate sizeable stake in a matter of seconds. Derivatives also enhance the capacity of shareholders to accumulate economic ownership in a short period of time. It is argued that there is no legitimate reason for a buyer of a sizeable stake to hide its transaction from the management, investment community and other shareholders for a 10-day period.[155] Therefore, the 10-day period is found to be outdated and needs to be shortened to prevent potential abuses by activist funds.

The concerns arising from individual investors' ability to purchase a stake are not well-established. The information about an underperforming company depends on the research of an activist fund; therefore, the information is a result of its own private efforts. Gilson and Gordon rightly ask: 'why does the selling shareholder have an entitlement to share in the value of information created by the analysis of other investors?'.[156] The decision to sell belongs to the existing shareholders, and there might be different motives behind an exit such as liquidity or dissatisfaction with management. Furthermore, Bebchuk and Jackson rightly argue that activist funds do not normally obtain control benefits and therefore other shareholders do not lose a control premium due to the fact that activist funds do not usually have a controlling

[154] Wachtell, Lipton, Rosen & Katz (n 146) 3.
[155] Wachtell et al., (n 146).
[156] Ronald Gilson and Jeffrey Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and The Revaluation of Governance Rights' (2013) 113(4) *Columbia Law Review* 863, 902-917.

stake in the listed companies.[157] The calls for reform would facilitate the free-riding strategy among investors. A shortened time window would significantly restrict the activist funds' ability to accumulate a sizeable stake, thereby reducing the returns of activist funds and the possible occasions of activism. Therefore, while shortening the time window appears to protect the interests of mainstream investors, it actually deprives them from the strategic monitoring and alternative business strategies presented by activist funds. Such restrictive disclosure rules can limit overall activism across the market and reduce its impact.

The second policy question relates to whether derivatives should be considered within the concept of 'beneficial ownership' or not. The concept of beneficial ownership includes 'voting power' or 'investment power' which refers to 'the power to dispose, or to direct the disposition of, such security'.[158] Other forms of ownership are not counted within the concept of beneficial ownership unless they confer a right to acquire beneficial ownership.[159] This fails to address positive risk-decoupling techniques, i.e. the situation in which shareholders have more economic interest and risk than actual voting power. This technique basically allows activist funds to avoid disclosure requirements by having economic ownership through cash-settled swaps and to influence the vote of the short-party as discussed in Chapter 3.[160]

Developments in financial markets and the importance of hidden ownership problems require a broad and consistent solution. The most effective and practical way to deal with these problems is to expand the definition of 'beneficial ownership' to include economic ownership or interests arising out of any swap agreement. Such a solution will remove any uncertainty regarding whether the swap holdings of shareholders constitute a scheme to avoid disclosure under section 13d. This solution would ensure the consistent application of the rule compared to a case-by-case

[157] Bebchuk and Jackson (n 146), 51.
[158] 17 C.F.R. § 240.13d-3.
[159] See, Henry Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 *Southern California Law Review* 811, 868.
[160] See also, *CSX Corp. v. Children's Investment Fund Management (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), affirmed in part, vacated in 654 F.3d 276 282 (2d Cir. 2011).

examination.[161] Such a solution is proposed by the Brokaw Act. The Brokaw Act would expand the concept of beneficial ownership by adding 'a pecuniary or indirect pecuniary interest in such security' to Section 13d-3(a).[162] So any shareholder would be required to include financial derivatives that do not provide voting rights within their calculation of the beneficial ownership. The increased disclosure requirements would enable mainstream investors to assess and to respond adequately to activist proposals. Consistent with this view, the Hedge Fund Working Group stated that 'companies have a right to know who owns them or who has an ability to easily obtain significant voting power' and endorsed the disclosure of economic-only interests, including swaps.[163] The proposed change is less likely to have a significant impact on activist investors and does not eliminate offensive activism because the ownership threshold and the time window would still enable them to recover their expenses. It is therefore workable without unduly undermining the business model of activist funds.

The third policy question relates to the formation of wolf-packs. It has been noted that wolf-packs can be created to implement abusive tactics. The voting power of a wolf-pack can easily reach 20% to 30% since it is risk-free for them because, in any event, the members of a wolf-pack will receive the immediate increase on the day of disclosure.[164] The formation of a wolf-pack actually depends on how the group of shareholders is interpreted under section 13(d)(3) of the Securities Exchange Act of 1934.[165] This section mandates that any group formed 'for the purpose of acquiring, holding, voting or disposing of securities of an issuer' shall be deemed as a 'person' under section 13(d). Wolf-packs can evade disclosure regimes in three different ways. First, all the members of the wolf-pack hold less than 5% of the target company's shares. Second, the leader of the wolf-pack might own more than 5% of the company's shares, but the others stay under the radar. Third, all members of the wolf-pack hold

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[161] Brian Sullivan, '*CSX Corp. v. Children's Investment Fund Management* and the Need for SEC Expansion of Beneficial Ownership' (2009) 87 *North Carolina Law Review* 1301, 1318.
[162] 17 C.F.R. § 240.13d–3.
[163] Hedge Fund Working Group, 'Hedge Fund Standards Consultation Paper Part 2: Best Practice Standards (2007) 60 <http://castlehall.typepad.com/risk_without_reward/files/hfwg20consultation20paper20part20ii.pdf> accessed 18 June 2017.
[164] John Coffee, 'Hedge Fund Activism: What Do We Know and Not Know' in William Bratton and Joseph McCahery (eds) *Institutional Investor Activism* (Oxford 2015) 693, 701.
[165] 15 U.S. Code § 78m.

more than 5% of the company's shares. Depending on the definition of groups, the actual size of a wolf-pack could be hidden from other shareholders, the board and management. The formation of wolf-packs can transfer power away from the board and shareholders to activist funds. Since wolf-packs could pursue controversial business strategies without bearing any actual economic risk, their interests might diverge from the interests of other shareholders and the board.

The courts unfortunately interpret the group narrowly. In *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*[166] the court rejected the claim that the discussion between investors about their purchases constitutes a group under Section 13(d) of the Securities Exchange Act. While there was evidence of coordination between hedge funds, the court did not consider wolf-packs to be the group. The narrow interpretation of 'group' has also been affirmed in *CSX Corporation v. The Children's Investment Fund Management*.[167] The Court of Appeal held that 'even if many of the parties' "activities" were the result of group action, two or more entities do not become a group within the meaning of section 13(d)(3) unless they "act as a . . . group for the purpose of acquiring . . . securities of an issuer' and further required 'a precise finding, adequately supported by specific evidence, of whether a group existed for purposes of acquiring CSX shares'.[168] It is difficult for the board and shareholders to notice the wolf-pack if some members of the wolf-pack have less than 5% of the target company because of the narrow interpretation of a 'group'. In short, wolf-packs cannot be deemed a 'group' under securities law unless there is very clear evidence of coordination between investors.

This raises one core question about how to limit the abusive tactics of activist funds through wolf-packs without restricting the overall regulatory framework. Instead of focusing on shortening the 10-day window or lowering the threshold, this thesis recommends an alternative approach. That is, re-defining the group might address concerns arising from a wolf-pack and does not constitute an overall limitation on shareholder activism. Similarly, the Brokaw Act proposed to add 'seeking to

[166] *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*, 286 F.3d 613 (2d Cir. 2002).
[167] *CSX Corp. v. Children's Investment Fund Management (UK) LLP.* 654 F.3d 276, 284 (2d Cir. 2011).
[168] CSX (n 167) 284.

control or influence the board, management or policies' and 'evading, or assisting others in evading, the designation as a 'person' under this paragraph' to section 13d-3 of the Exchange Act. Implementing these changes would help boards and mainstream investors to be aware of any sizeable accumulation of shares. It would not prevent individual activist funds from accumulating a toehold stake, but when they communicate with each other, their total ownership would be used to determine if they cross the ownership threshold.

The final policy question is related to the disclosure of short-positions. Unlike long-positions, US securities legislation does not require investors to disclose their short-positions.[169] The Brokaw Act would require shareholders to disclose any short-interest representing more than 5% of the shares of a company. As discussed in Chapter 3, risk-decoupling techniques give rise to significant public concerns in the wake of the financial crisis. Section 929X of the Dodd-Frank Act provided the SEC authority to promulgate disclosure requirements for short-positions. In academia, there are dissenting views regarding whether disclosure could fail to address problems associated with the short-positions of shareholders. Therefore, a complete ban on risk-decoupling strategies is proposed by Thompson and Edelman.[170] Such a holistic approach does not provide satisfactory solutions where the problem is not black or white.[171] As discussed in Chapter 3, risk-decoupling techniques also generate benefits to corporate governance. Short-selling activities bridge the gap between overvalued shares and the real value of shares, reveals new information about underperforming companies and instances of misconduct at companies, and enhances liquidity. In the context of hedge fund activism, it is usually used in the form of empty voting. This thesis therefore does not support a complete ban on risk-decoupling techniques and considers enhanced disclosure an adequate solution to the problems of risk-decoupling. Hedge funds in Australia, the UK and US opposed the enhanced

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[169] See, Alon Brav, James Heaton, and Jonathan Zandberg, 'Anti-Activist Legislation: the Curious Case of the Brokaw Act' (2016) 22 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860167 > accessed 16 May 2017; Elizabeth Howell, 'Short-Selling Reporting Rules A Greenfield Area' (2015) 12 *European Company Law* 79.
[170] Robert Thompson and Paul Edelman, 'Corporate Voting' (2009) 62 *Vanderbilt Law Review* 129, 153.
[171] Wolf-Georg Ringe, 'Hedge Funds and Risk Decoupling: The Empty Voting Problem in the European Union' (2013) 36 *Seattle University Law Review* 1027, 1084.

disclosure requirements and argued that the hedge fund industry would be significantly diminished if they were required to disclose detailed information regarding short-selling positions.[172] The risk-decoupling techniques cause governance concerns because shareholders, the board and management do not have sufficient information to assess adequately whether the motivation behind activist proposals is consistent with corporate policies and objectives. Where the board and shareholders know that activist funds hold stakes on both sides of a deal, they might develop counter-measures such as revising the voting policies.[173] Enhanced disclosure would likely deter activist funds from engaging in controversial risk-decoupling. Once it is known that they follow their private interests through shareholder proposals, they face negative reputational consequences. Unsurprisingly, many academics and practitioners have advocated enhanced disclosure as a solution to the problems discussed in Chapter 3.[174] The individualised reporting requirement for short-positions would significantly enhance US corporate governance and the functioning of contemporary shareholder activism. It would also address the problems arising from the negative interests of shareholders while the benefits of short-positions could still be still realised without unduly prejudicing activist funds.

To conclude, there are calls for the reform of the enhanced disclosure rules to constrain unwanted behaviour of activist funds. Activist funds play an important role in corporate governance. Implementing the proposed changes, broadening the concept of beneficial ownership, narrowing the definition of group, regulating short-positions, and maintaining the 10-day time window would limit the controversial behaviour of activist funds and enhance the functioning of contemporary shareholder activism without unduly undermining the business model of activist funds.

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[172] Peter Smith, 'Fund heads voice short selling fears' *Financial Times* (2009) https://www.ft.com/content/3cd7b992-dc84-11dd-a2a9-000077b07658?mhq5j=e2 accessed 17 June 2017.
[173] Ringe (n 171) 1087.
[174] Henry Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownerhsip' (2006) 79 *Southern California Law Review* 811, 875; Marcel Kahan and Edward Rock, 'Hedge Funds in Corporate Governance and Corporate Control' (2007) 155 *University of Pennsylvania Law Review* 1021, 1077.

6.5 Conclusion

This chapter has argued that the director primacy theory model should be softened to accommodate the evolving role of shareholders in US corporate governance. Shareholder activism could be accommodated within the US corporate governance regime while preserving the value of board authority. Shareholder activism serves a managerial error-correction role rather than the exercise of authority. It is therefore possible to address accountability concerns through shareholder participation while preserving sufficient discretionary room for directors. Shareholder activism makes the board truly independent of management and enhances the decision-making of companies by challenging the board and engaging with it. Therefore, director primacy should not survive in its near-absolute form. the proposed softer version of director primacy can be embraced by the corporate governance regime in the US and courts instead of the near-absolute conception of the theory. This softer version of director primacy could more effectively address accountability problems in public companies while recognising the role of the board of directors. Any corporate governance reforms should aim to empower shareholders to incorporate their views on the future direction of companies rather than seeking to thwart them while still preserving the board's authority. In this regard, UK corporate governance shows that the board's authority is indeed compatible with strong shareholder participatory rights.

This thesis recommends the creation of a level playing fields for private orderings and making director elections more meaningful. Implementing these proposed changes would make US corporate governance flexible enough to accommodate shareholder activism. This study also suggests regulating the role of shareholders in securities law. An enhanced disclosure regime has the potential to curb the darker side of activist funds without unduly prejudicing them. These changes would enable US corporate governance to conform with contemporary shareholder activism, while remaining consistent with its traditional approach.

Chapter 7. Conclusion

7.1 Summary of Theoretical Findings

This thesis has provided an account of, and the reasons for, shareholder activism. Better corporate governance can be secured by considering the evolving role of shareholders in the context of the market and policy developments. The central aim of this thesis was to answer the question of whether and how the director primacy model prevalent in the US corporate governance system should be softened to accommodate this evolving role of shareholders.

Chapter 2 demonstrated how shareholders are traditionally relegated to the sidelines in corporate governance as a consequence of contractarian and director primacy theories. Under these theories, the role of shareholders is to provide capital with the expectation of receiving a rate of the total return generated by the company. Shareholders have neither financial incentives nor sufficient managerial skills to participate in the decision-making processes of companies. It is also argued that shareholders are not willing to engage in the decision-making processes of companies because of a number of legal obstacles and non-legal issues, such as free-rider and collective action problems. Director primacy theory highlights the economic efficiency and necessity of the board's centralised decision-making authority and argues that this limited role of shareholders is the way it ought to be because shareholder activism comes at the expense of board authority. Since there is an inherent trade-off between accountability and authority, shareholder activism is found value-reducing and economically inefficient. Therefore, under director primacy theory company law should promote centralised decision-making through the board as much as possible and shareholders should not be entitled to interfere in the decision-making processes of public companies.

In the absence of shareholder participation, reliance is placed on other accountability mechanisms, namely the market for corporate control, remuneration contracts, non-executive directors and external auditors to provide sufficient accountability in public companies. In addition, it relies on the board's dynamics to oversee management and directors. However, each accountability mechanism is subject to its own inherent limitations and fails to provide sufficient monitoring of management. The dynamics of the board are not as strong as director primacy theory assumes because the board can be under the influence of management due to the informational advantages enjoyed by management and the re-election concerns relating to independent directors. This over-reliance on management impedes the board from exercising effective control of management. The Barings, Enron, and Lehman Brothers failures demonstrated that the modern board of directors often fails to carry out the unique combination of managerial and monitoring roles that is expected and assumed by director primacy theory. There is therefore a gap in the monitoring mechanisms, and the need for a better functioning corporate governance.

Chapter 3 showed that shareholder activism could potentially play an important role in monitoring directors and managers. It concluded that the evolving role of shareholder activism is normatively desirable in corporate governance, despite the potential problems that might arise from shareholder participation and found no solid support for anti-empowerment rhetoric. The present research examined the main advantages of the evolving role of shareholder activism in corporate governance from two perspectives: a- shareholder activism as an accountability mechanism to promote shareholders' own private interests, and b- shareholder activism as an accountability mechanism to facilitate long-term investments and ensure the sustainability of companies and the economy in general.

In terms of shareholder activism as an accountability mechanism for shareholders' own private interests, shareholder activism in Hirschman's framework seeks to change corporate policies rather than exit the company.[1] Institutional shareholders aim to influence the board according to their point of view, so shareholder activism can be driven by many different motives. While some shareholders aim to protect existing stakes at a particular company, activist funds perceive activism as an investment strategy. Alternatively, some funds focus on corporate social responsibility issues. In this respect, neither empirical evidence nor the short-termism versus long-termism debate casts any light on the desirability of

[1] Albert Hirschman, *Exit, Voice, and Loyalty* (Harvard University Press, 1970) ch 3.

shareholder activism in corporate governance. The underlying issue with regards to shareholder activism is the conflicting views between shareholders and the incumbent management about the direction of the company's policies. From this perspective, the role of shareholder activism is an early warning mechanism regarding the possible underperformance of management, i.e. it is a feedback mechanism to the board. Therefore, it functions alongside the board of directors. Shareholder activism, therefore, may address accountability concerns and reduce agency problems by warning the board about the underperformance of management. This underperformance may not only be related to financial issues, but also non-financial issues. Shareholder activism has the potential to play a preventive role with regards to the underperformance of companies before it is too late to take corrective action. The main advantages of shareholder activism are the increased accountability in public companies, improved monitoring mechanisms, and better engagement between the board and shareholder base. Hirschman's framework also demonstrated that companies benefit from shareholder activism to varying degrees. So, while shareholder activism might be beneficial for some companies, it might be excessive for others. Shareholder activism is not inherently good or bad. The boards, therefore, should be able to adjust the appropriate level of activism with the help of shareholders.

In terms of shareholder activism as an accountability mechanism to facilitate long-term investments and ensure the sustainability of companies and the economy in general, shareholder activism is used as a means of addressing public interest concerns such as short-termism in the market. Major institutional shareholders established the Stewardship Principles. These principles could be a turning point for US corporate governance because they open a door between companies and institutional shareholders allowing both sides to develop a constructive dialogue and forms of engagement. The promulgation of such principles shows that institutional shareholders share responsibility for the sustainability of portfolio companies. This is a new paradigm in the US where shareholders and directors have often had a strained or even confrontational relationship. Such engagement is more collaborative in nature than is assumed by the shareholder primacy and director primacy theories. This kind of activism could play a supportive role for the board of directors when they have contact with activist funds and decide to invest for the long-term. In this respect, this thesis considers that such collaborative activism also helps the board to maintain its authority and recalibrates the relationship between directors and shareholders.

The present thesis also discussed the potential problems relating to shareholder activism from different perspectives, namely the short-termism argument, the conflicting interests of shareholders, risk-decoupling techniques, and stakeholder theory. This thesis argued that the short-termism versus long-termism debate fails to shed light on the desirability of shareholder activism because companies operating in a competitive market might benefit from immediate feedback from shareholders. Shareholder activism, therefore, should be evaluated in the context of the 'right-termism' relevant to the company. The differing interests of shareholders has been criticised because it is often argued that they might pursue goals other than shareholder wealth maximisation. However, this thesis finds such activism consistent with the general approach of company law which allows the board to consider stakeholder concerns. Shareholder activism is also criticised on the grounds of stakeholder concerns. A different version of the director primacy model that does not provide sufficient room for shareholder participation is examined. This thesis concluded that shareholder activism could be a means of advancing stakeholders' concerns. The present research also investigated the problems by shareholders who engage in risk decoupling. A potential drawback of risk decoupling techniques was identified. With the help of these techniques, shareholders can increase their influence over the board and management and force them to pursue business strategies which benefit a particular shareholder rather than other shareholders and the company. Therefore, these techniques raise significant corporate governance concerns. Despite this potential problem, this thesis found no solid basis for a complete insulation of the board and management from shareholder participation. Therefore, lawmakers should not overemphasise the potential problems regarding shareholder participation. Overall, the present research concluded that the evolving role of shareholder activism is desirable in corporate governance.

The success and practicability of shareholder activism as an accountability mechanism to promote shareholders' own interests and ensure the sustainability of companies and the economy in general depends on the individual capacity of institutional shareholders to exercise formal and informal means of such activism. In other words, institutional shareholders must be able to overcome free-rider and collective action problems for shareholder activism to function meaningfully. Chapter 4 demonstrated that the share ownership of public companies has transformed from individual to institutional ownership. Against this background, shareholder activism becomes more likely with the re-concentration of shares in the hands of institutional shareholders.

Chapter 4 also demonstrated that share ownership is not the sole determinant of shareholder activism because each institutional shareholder has different business models, which play a significant role in shaping their activism. The business models of institutional shareholders consist of different factors such as the liability structure, the fee structure of the external and internal fund managers, the investment strategy of funds, and the political and social purposes of the funds. As a result of the combination of these factors, institutional shareholders or their fund managers may hesitate to engage in activism, even though such activism would increase the value of portfolio companies, i.e. would be beneficial for the ultimate beneficiaries. In this respect, the analysis of institutional shareholders has demonstrated that mainstream institutional shareholders, namely large pension funds, mutual funds, insurance companies and sovereign wealth funds are long-term investors. These major institutional shareholders are not passive in the Berle-Means sense. They have transformed from 'rational passive investors' to 'rational reticent investors'. In particular, large mainstream institutional shareholders have sufficient resources to establish constructive engagement with the boards. They could potentially carry out the stewardship responsibilities, but they are more likely to refrain from initiating confrontational activism against the board or developing shareholder proposals addressing agency gaps in corporate governance because of their business models.

Hedge funds fill this important niche in corporate governance. They have a unique business model in which the fee structures and the disclosure regime play a key role for hedge funds, driving them to exercise offensive activism. They can identify underperforming targets, accumulate sizeable stakes, and present an alternative business strategy to the board and shareholders. The present research considers hedge funds an important disciplinary means over management by revealing the flaws in the incumbent management's business strategy. Hedge funds provide a genuinely alternative approach with regards to the future direction of the target company. This study does not unconditionally favour hedge funds because it is not uncommon for them to pursue their own private interests through a number of controversial tactics such as wolf-packs, golden leashes and risk-decoupling techniques, which raise corporate governance concerns. As such, this thesis adopted a balanced approach rather than accepting either polar characterisation of hedge funds. Overall, the awakening of mainstream shareholders and the emergence of activist shareholders are at odds with the assumptions of contractarian theorists with regard to the role of shareholders. The present thesis concluded that the evolving role of institutional shareholders in corporate governance should be taken into consideration in the future direction of company law and should be accommodated in corporate governance.

7.2 The Analysis of US Company Law

This thesis established a theoretical framework for the importance of shareholder activism in corporate governance, and how the role of shareholders envisaged by law and economic approaches have been converted into practice in the market. Along with shareholders' economic power, it is crucial to understand how the theory of the role of shareholders has been translated into practice within the US legal framework.

In this thesis, the aim was to draw a clear picture of US legal and regulatory rules which reflect director primacy theory. In this investigation, the aim was to evaluate the extent to which shareholder activism is practicable in US corporate governance. State law, federal law, and market developments in the post-crisis era have been examined and evaluated. Additionally, the judiciary's understanding of the board authority has been critically examined. One of the main findings of this examination was that shareholders have long been impeded from participating in the governance of companies and even effectively exercising their shareholder rights under state law. The courts have developed an understanding of the board that confers on it near-absolute authority. Delaware and federal law have overregulated shareholder activism. Modernisation in these areas is much needed to reflect the evolving role of shareholders.

The findings of Chapter 5 showed that Delaware law and federal law have been in flux in terms of shareholder power for a long time, and the anti-shareholder empowerment rhetoric of director primacy theory has significantly influenced the legal and regulatory reform process. Shareholders were traditionally accorded a 'spectator' or 'bystander' role in US corporate governance.[2] Even in the post-Enron crisis era, shareholder participation has not been a priority for lawmakers, although shareholder protection has been a concern for them. Stronger shareholder rights have been found to be potentially destructive for corporate governance, and unnecessary because of the market for corporate control.

Chapter 5 discussed how the courts have also played a role in attributing a spectator role to shareholders. US company law mandates that companies are managed by or under the direction of a board of directors. The courts have shown strong deference to the board's authority under the business judgement rule, enhanced scrutiny, and entire fairness tests. The judiciary developed the business judgment rule to protect the exercise of managerial power by the board. In this context, it is very difficult for shareholders to rebut the presumption that 'in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company'.[3] In this way, the substance of corporate decisions is protected. The standard of review shifts to the enhanced scrutiny test where there are some situations that could potentially affect the judgement of even independent and disinterested directors. The standard shifts to the entire fairness test where the majority of directors are not sufficiently independent and disinterested. The analysis of these three standards of review revealed that the board is shown strong deference when it exercises power or fails to act. The courts rely on the market for corporate control and director removal, election and re-election mechanisms to prevent any adverse implications of this strong reliance.

[2] Christopher Bruner, *Corporate Governance in the Common-Law World* (Cambridge 2013) 38; Mathias Siems, *Convergence in Shareholder Law* (Cambridge 2011) 63; Jennifer Hill, 'Visions and Revisions of the Shareholder' (2000) 48(1) *The American Journal of Comparative Law* 39, 47.
[3] *Aronson v. Lewis* 473 A.2d 805, 811-2 (Del. 1984).

However, this rationale was challenged in Chapter 5 because shareholders cannot effectively replace directors.

The courts apply the enhanced scrutiny test, i.e. the Unocal test where the board has adopted defensive mechanisms. These defensive mechanisms were mostly employed in the context of takeovers, but recently the board began employing defensive mechanisms in the context of shareholder activism. Chapter 5 revealed how the application of the Unocal test could be over-restrictive for shareholders to engage because a fundamental aspect of shareholder activism is to influence or change corporate policy and effectiveness. Furthermore, the courts accepted that the possibility that activist funds are acting together could also be a threat to corporate policy. In this respect, defensive mechanisms will dilute the voting power of activist shareholders and make shareholder activism less likely. Chapter 5 also showed that the logic behind upholding defensive mechanisms is that shareholders cannot make informed decisions. Chapter 5, therefore, suggested that the Delaware courts should re-consider its existing assumption regarding shareholders and recognise the evolving nature of institutional shareholders as depicted in Chapters 3 and 4 in order to fully realise the benefits of shareholder activism.

Chapter 5 also examined how shareholders are slowly moving to the centre of corporate governance through private ordering mechanisms. The increasing economic power of institutional shareholders has led them to initiate a transformative process towards more shareholder friendly corporate governance through by-law amendments on a company-by-company basis. Such transformation has accelerated in the wake of the 2007-2008 financial crisis with the removal of the impediments against shareholders' proxy access to director elections. In fact, institutional shareholders have achieved considerable success in reducing the number of staggered boards, anti-takeover mechanisms and plurality voting rules, and in adopting proxy access in director elections, the separation of chairman and CEO positions, and the right to convene shareholder meetings. The impact of these shareholder proposals is not limited to these areas; they increase shareholders' overall disciplinary power. For instance, where a company has a staggered board, shareholders could remove directors only with cause. The removal of staggered boards has also increased the power of shareholders to remove directors. As a result, by-law amendments through Rule 14a-8 provided shareholders with greater private ordering autonomy. In addition to changes through private orderings, the Dodd-Frank Act expanded shareholders' rights to say on pay. Chapter 5 argued that US corporate governance is becoming more shareholder friendly.

The present research demonstrated that this transformation has not been perfect and has suffered from major deficiencies. Chapter 5 showed that directors also respond to this transformation by adopting by-laws to restrict shareholders' rights or the ability to exercise shareholder rights. Both shareholders and directors appear to have equal power to adopt, amend and repeal by-laws under section 109 of the DGCL. However, Chapter 5 showed that shareholder authority to adopt, amend and repeal by-laws is more limited than the board's authority, even though shareholders possess statutory power while directors' power originates from the charter itself. The courts developed divergent treatment for shareholder-and board-adopted by-laws. This thesis argued that the power imbalance between shareholders and directors does not arise from section 109 of the DGCL, but rather from the strong interpretation of section 141 by the courts. Such divergent treatment of shareholder-adopted and board-adopted by-laws could be used by directors to undermine the value of shareholder activism in US corporate governance. Additionally, it is not clear whether directors could repeal or amend shareholder-adopted by-laws under section 141(a). The interpretation of the courts and the ambiguity surrounding whether directors could repeal shareholder-adopted by-laws highlight the need for clarity in the statutory language to allow shareholder activism to function better and not be undermined by the courts.

This study indicated proxy regulations as one of the most important tools of shareholder activism in the US because in public companies dispersed shareholders mostly use Rule 14a-8 to submit shareholder proposals. In essence, the primary purpose of Rule 14a-8 is to make state-based shareholder rights practicable. The findings of the present research demonstrated that Rule 14a-8 has long impeded shareholders from submitting shareholder proposals by providing the board and management with thirteen grounds for exclusion. One of the exclusion grounds was related to director elections. Rule 14a-8 prevented shareholders from submitting shareholder proposals relating to director elections until the Rule was changed in 2010. This ban not only covered the nomination of a particular director, but also included shareholder proxy access by-laws, i.e. company specific procedures for the nomination process. In addition, there are merit-based exclusion grounds, namely conflicts with state law, the ordinary business exclusion, and relevance. The board and management mostly rely on the ordinary business exclusion ground due to its broad and vague definition. These exclusion grounds show that the mere submission of shareholder proposals was considered a potential threat to corporate governance. This rule had been put in place before shareholder activism became an important aspect of US corporate governance. Chapters 3 and 4 demonstrated that the nature of shareholder activism has evolved, and shareholder activism does not constitute a threat to corporate governance. Moreover, Chapter 5 showed that these proposals are an important means of addressing accountability concerns and agency problems and making the board responsive to shareholder concerns. It needs to be revised to reflect the changing role of shareholders.

The present research also examined the process of director elections. Director elections are not only a disciplinary mechanism that shareholders have, but also underscore the legitimacy of directorial power. The analysis has shown that while shareholders have state-based rights to nominate directors, proxy regulation has long prevented shareholders from exercising such rights. In the wake of the 2007-2008 financial crisis, the SEC removed the barriers to shareholder nomination by-law proposals and adopted proxy access, but the court invalidated the mandatory proxy access regulation. Without these reforms, the power of shareholders to nominate and replace directors were illusory. Shareholders are now able to adopt shareholder nomination by-law proposals, but they still do not have proxy access. Additionally, under state law, the default regime for elections is plurality voting. Chapter 5 demonstrated that the dissatisfaction of shareholders has no practical effect on the directors. Overall, such a restrictive framework limits shareholders' ability to nominate directors which could potentially address the short-comings of the monitoring board, i.e. the overreliance on management and the information asymmetry between the board and management. Chapter 5 therefore challenged the rationale for strong deference to the board, which is that shareholders are able to replace directors when they are dissatisfied with them. This analysis implies that the legal framework should enable shareholders to nominate directors and to show their dissatisfaction.

In summary, the results of Chapter 5 indicated that while market developments through private ordering and the legal reforms in the wake of the financial crisis have made US corporate governance more shareholder friendly, some issues still remain problematic. The practicability of shareholder activism remains subject to limitations.

7.3 Accommodating Shareholder Activism within the US Corporate Governance Model

The aim of Chapter 6 was to understand whether director primacy theory should be softened to the extent to that it could accommodate shareholder activism. The chapter therefore contributed to existing knowledge regarding the practicability of shareholder activism under director primacy theory and provided possible remedies to the main impediments to such activism and the potential problems of shareholder activism.

The discussion in Chapter 6 argued that the principles of accountability and authority could work together and should be read together. It concluded that director primacy should be softened to the extent that it can accommodate the evolving role of shareholders. Corporate governance should be built around the principles of authority and accountability. As such, rather than discussing who should have ultimate control in corporate governance, the delicate task of corporate governance should be to address accountability problems while preserving sufficient room for directors to manoeuvre.

Chapter 2 demonstrated that the core attributes of corporate governance in the context of the allocation of power between shareholders and directors are the concepts of authority and accountability. Since these concepts have been found incompatible with each other, it has led to a protracted discussion of shareholder primacy and director primacy theories. The discussion in Chapter 6 proposed a toned-down version of director primacy which recognises the value of shareholder activism as well as centralised management. In this model, the allocation of power is not thought of as a zero-sum game in which there is an inherent trade-off between authority and accountability. Rather than discussing who should have the ultimate control in corporate governance, the delicate task of corporate governance should be to address accountability problems while maintaining sufficient discretionary power to the board of directors.

The features of contemporary shareholder activism make the milder version of director primacy theory possible. The discussions in Chapters 3 and 4 showed that current shareholder activism is not only confrontational, but also constructive for the incumbent board and management. Chapter 6 showed that the evolving role of shareholder activism is to bring moderation to the inherent power imbalance between shareholders and directors by challenging the board of directors and establishing shareholder engagement with the board. The softer version of director primacy theory is consistent with market developments because it forces us to stop thinking of shareholders as just providers of capital who are only interested in short-term wealth maximisation. This broader understanding encompasses the evolving role of shareholders in which shareholders are willing to incorporate their financial and non-financial concerns into the decision-making of public companies. It addresses accountability problems more effectively than the traditional director primacy theory and significantly enhances the monitoring and decision-making capacity of the board. Moreover, it makes the board more critical of management in exercising judgement and decision-making, which is a prerequisite for director primacy theory to function. In principle, company law should therefore not block shareholder activism.

Contemporary shareholder activism serves two main functions: challenging the board and establishing engagement with it. Chapter 6 demonstrated that neither of these functions transfer power from directors to shareholders. With regards to the first function, activist funds challenge current corporate policies of incumbent management. In doing so, they reveal the flaws in the corporate policies or governance structure of the investee companies and bring new information to the boardroom and shareholders. This enhances the monitoring and decision-making capacity of the board of directors by addressing information asymmetry problems between the board and managers. In some cases, they directly appoint the directors, who are not afraid of speaking out against the management. In essence, activist funds raise legitimate questions in the boardroom. When a corporate decision is contested, the role of the board becomes that of arbitrator between activist investors and the incumbent management. The board has two basic options: to accept the proposed changes or to decline them. In both cases, the board has to explain and justify its decisions. It forces the board to be more critical of the management's actions. Thus, it plays a managerial error corrective function rather than a decision-making role by raising legitimate questions and forcing the board to obtain more information about the strategy. Overall, this aspect of shareholder activism helps to break the overreliance of the board on management which was identified as a major short-coming of current boardrooms. In this regard, the board becomes truly independent of management.

In relation to the second function, Chapters 3 and 4 demonstrated that mainstream investors tend to establish constructive activism with the board and management. This aspect of activism is a key factor in the board's success against offensive activism. Chapter 6 argued that it enhances the board's authority because where the board provides ex ante explanations with regard to corporate decisions, mainstream investors tend to support the board and management against activist funds. In this way, it reduces the number of needless confrontational shareholder activism actions. Where the voice and concerns of a majority of shareholders are adequately taken into consideration, these shareholders are less likely to support activist funds. As such, shareholder activism, i.e. accountability, becomes a means of ensuring the authority of the directors.

Chapter 6 also examined the UK's corporate governance framework in terms of the allocation of power to enhance our understanding of the relationship between authority and accountability. Chapter 6 showed that UK company law provides shareholders with strong participatory rights as well as directors with authority. The board's authority is well protected under UK company law. The analysis showed that strong participatory rights do not equate to ultimate control of public companies, but rather only require the board to provide ex ante explanations for their decisions. In other words, it still functions within the boundaries of the concept of accountability. Therefore, they only bring moderation to the corporate discussion table.

Chapter 6, therefore, showed that it is possible to address accountability problems in public companies while leaving sufficient discretionary room for directors. It concluded that director primacy theory should not survive in its current form but should instead be softened in its approach to authority and accountability. To this end, Chapter 6 made a number of recommendations to render US corporate governance sufficiently flexible to accommodate the evolving role of shareholder activism. These recommendations aim to improve the disciplinary role of shareholders and to enhance the decision-making of companies, while recognising sufficient room for directors. In creating a better framework for an attenuated version of director primacy theory, the following themes should be considered by policy-makers: a- the value of board authority b- the emergence of activist funds and the awakening of mainstream institutional shareholders, c- the functionality of authority and accountability together, d- the possibility of private benefit extraction through risk-decoupling techniques and wolf-packs, and e- the possibility of excessive shareholder activism. The primary aim is therefore to establish a delicate balance between shareholder activism and the board's authority.

With this objective in mind, the present research suggested creating a level playing field in terms of private orderings, making director elections more meaningful and enhancing the disclosure obligations of shareholders. Chapter 5 demonstrated that shareholder proposals are the most important tool that shareholders can use to make changes to the governance structures of investee companies. However, Chapter 5 argued that although the boards and shareholders' power to adopt, amend and repeal by-laws originates from section 109, the courts have narrowly interpreted shareholder power compared to the board's power. Chapter 6 argued that this divergent treatment arises from the recursive loop between sections 109 and 141, and also the hard interpretation of director primacy by the courts. It appears that without any clarification in the law, such narrow interpretations will likely remain. In this respect, this thesis firstly suggested adding the phrase 'procedural or substantive' to section 109(b) in order to remove the artificial distinctions between procedural or substantive bylaws created by the courts, and to add 'the by-laws may not be used to mandate the decision itself' to the same section to prevent shareholders from directing directors. Secondly, it recommended adding the term 'in its by-laws' to section 141 to indicate that limitations might come from by-laws as well. Thirdly, in order to remove an ambiguity surrounding whether or not directors could amend shareholder-adopted by-laws, this study suggested adding ‘the board cannot amend a shareholder by-law unless otherwise stated in the by-law’ to section 109.

By-laws are usually submitted through Rule 14a-8. Chapter 5 demonstrated that Rule 14a-8 provides the board with very broad discretionary power to exclude shareholder proposals. Chapter 6 showed that Rule 14a-8 fails to reflect the market and policy developments. This thesis recommended the removal of the ordinary business and relevance exclusion grounds to make proxy regulation consistent with state law. Chapter 6 also argued that the $2000 threshold in Rule 14a-8 is outdated and instead recommended the application of a 1% ownership criterion to prevent shareholders who have immaterial ownership of the company from submitting shareholder proposals.

Chapter 5 showed that shareholders have long been impeded from participating in director elections. Although the SEC removed barriers to shareholder nomination by-law proposals, the discussion in Chapter 6 argued that this development is not satisfactory and fails to allow shareholders to participate in director elections. The analysis in Chapter 6 suggested a shift from a plurality voting to majority voting rule, from a no-access to default access regime, and the adoption of universal proxy cards to provide shareholders with a genuine opportunity to participate in director elections.

Chapter 6 demonstrated that the influence of mainstream institutional shareholders is of significant importance if shareholder activism is to play a managerial error-correction function and enhance the decision-making of public companies. Chapters 3 and 4 examined how activist shareholders could change the balance towards themselves without bearing the economic consequences of their actions through risk-decoupling techniques and wolf-pack tactics. These controversial methods allow activist funds to evade disclosure requirements. Chapter 6 therefore suggested regulating the role of shareholders in securities regulation. The aim was to curb the potential darker side of offensive activism without completely eliminating the business model of activist funds. In this respect, Chapter 6 examined the proposed

Brokaw Act[4] seeking to amend the disclosure requirements of activist funds. It concluded that shortening the time window of disclosure could significantly undermine the business model of activist funds. It also found that broadening the scope of beneficial ownership, redefining 'group' for the purpose of shareholders acting in concert and including short-positions could address the potential concerns arising from the activities of activist funds.

In summary, this thesis has critically analysed the evolving role of shareholders in corporate governance. It has assessed both the advantages and disadvantages of shareholder activism and has highlighted why the potential problems with shareholder participation should not be overemphasised. It has demonstrated the evolving nature of the shareholder base of public companies. The findings showed that the role of shareholders as capital providers fails to embrace the emerging role of shareholders. Activist shareholders are now willing to criticise existing business strategies, and major mainstream institutional shareholders are willing to contribute to the development of important corporate policies and to support long-term value creation. Alternatively, some institutional shareholders incorporate ESG and CSR issues into their investment policies. This is at odds with director primacy theory and US corporate governance. This research examined the key elements of shareholder activism in US corporate governance to understand how US corporate governance could accommodate the evolving role of shareholders. Further recommendations have been proposed to address the short-comings identified in US companies by considering the developing role of shareholders, the potential darker side of shareholder activism and the possibility of excessive shareholder activism.

The general finding of this thesis is that there is a need for shareholder activism in corporate governance. It is not only a monitoring mechanism, but also a means of improving decision-making of public companies. It helps to enhance the independence of the board and to function as the ultimate decision-making authority of public companies. It could also contribute to the sustainability of companies by incorporating ESG issues and supporting the long-term investments of portfolio companies. It functions as an early warning mechanism that helps the board and management to

[4] The Brokaw Act, S. 2720, 114th Cong. (2016).

understand the potential weaknesses in their corporate policies before they become too late. Hence, it could play a preventative role in corporate governance.

7.4 Limitations of the Current Study and Recommendations for Future Studies

This thesis has intended to examine the evolving role of shareholders in US corporate governance in light of the prevailing theoretical and practical aspects in the literature. However, a number of important limitations of findings advanced in this thesis should be considered.

Chapter 4 has demonstrated that whether institutional shareholders exercise different levels and quality of activism depends on their business models. Chapter 6 also discussed the importance of the role of mainstream institutional shareholders to screen the proposals of activist funds. Their role is also crucial for the success of activist funds. Their capacity to exercise informed activism is central to good governance.

Chapter 3 showed how major mainstream institutional shareholders developed a set of Stewardship Principles that require institutional investors and asset managers to disclose how they evaluate corporate governance factors in terms of portfolio companies. The Principles also encourage asset owners and managers to engage in constructive shareholder activism and to work with other institutional investors. The present research found this development to be promising overall in terms of guiding institutional investors towards an activism culture and letting directors know what their investment approach is likely to be and how the shareholder base will react.

However, this thesis has not gone further to examine how the monitoring capacity of mainstream institutional shareholders could be further enhanced. In this respect, the relationship between fee arrangements (between external managers and the institutional funds, and internal managers and the institutional funds) and the quality of shareholder activism could be examined in more depth. This is highly important because, as Chapter 4 argued, even if the benefit of shareholder activism is considerable for the ultimate beneficiaries of institutional shareholders, its reflection on the salary of fund managers may be immaterial. It may discourage fund managers to take action. Alternative fee arrangements should therefore be investigated further. Another related issue is that of the distribution of the cost of shareholder activism between institutional shareholders and external funds. A policy solution within the institutional investment industry should be investigated.

Chapter 4 also made the point that the way in which mainstream institutional shareholders measure the success of fund managers has also had an impact on shareholder activism. Further examination is warranted of the possibility of stewardship responsibilities as an alternative mechanism to evaluate the success of fund managers. The relationship between measuring the success of fund managers through absolute or relative performance and the quality of shareholder activism also merits closer attention. In this respect, a principle consistent with the dynamics of the investment industry should be developed.

Chapter 4 showed that institutional shareholders often delegate the fund management activity to external fund managers. The monitoring capacity of these fund managers could be problematic in terms of shareholder activism. For instance, one fund manager declared that it attended more than 15,000 annual general meetings.[5] This illustrates how exercising considered activism could be challenging for asset managers in practice if they have not developed an engagement culture and do not have a sufficiently large workforce.

Another issue that was not examined is the problem of the long and complex investment chain involving consultants, funds of funds, and fund managers that places asset owners and the ultimate beneficiaries even further away from the portfolio companies. This has negative implications for the monitoring activities of investors because it causes 'a tendency to view market effectiveness through the eyes of intermediaries rather than companies or end investors'[6] and weakens the 'sense of accountability between the ultimate investor and the investee company'.[7] David

[5] Simon Wong, 'Is Institutional Investor Stewardship Still Elusive?' (September 2015) *Butterworths Journal of International Banking and Financial Law* 508, 510.
[6] John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision-Making* (July 2012) 10.
[7] Simon Wong, 'Why Stewardship is Proving Elusive for Institutional Investors' (July/August 2010) *Butterworths Journal of International Banking and Financial Law* 406 407.

Swensen, the former Chief Investment Officer of Yale University's Endowment, described 'funds of funds' as 'a cancer on the institutional-investor world' and argued that they cause ignorant capital in the investment chain.[8] Future research will need to focus on whether the investment chain should be shortened.

The final issue that has not been covered in this thesis is the use of loyalty-promoting instruments such as loyalty shares. Several jurisdictions such as France and Italy have started to employ the concept of loyalty shares to encourage long-term share ownership.[9] The potential impact of loyalty-promoting instruments on activism by mainstream institutional shareholders, activist funds and the principle of one-share-one-vote should be researched in much greater detail.

In summary, the present research has indicated that there are many questions regarding shareholder activism and the governance structure of institutional shareholders. Within these areas of investigation, it is recommended that the abovementioned limitations be examined in future studies.

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[8] Craig Karmin, 'Yale's Investor Keeps Playbook' *The Wall Street Journal* (13 January 2009) < http://www.wsj.com/articles/SB123180744823875647> accessed 04 August 2016.

[9] Jeroen Delvoie and Carl Clottens, "Accountability and Short-Termism: Some Notes on Loyalty Shares" (2015) 9 *Law and Financial Markets Review* 19.

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